

DEPARTMENTS OF TRANSPORTATION, TREASURY, THE JUDICIARY, HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2006

THURSDAY, APRIL 7, 2005

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Christopher S. Bond (chairman) presiding.

Present: Senators Bond, Murray, and Dorgan.

DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

STATEMENTS OF:

MARK W. EVERSON, COMMISSIONER

J. RUSSELL GEORGE, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning. The Senate Appropriations Subcommittee on Transportation, Treasury, Judiciary, Housing, Urban Development, and Related Agencies will come to order. I'm going to have to get used to that, Senator Murray. The committee is often called the THUD committee but we will go with the full name for this event.

We welcome Internal Revenue Service Commissioner Mark Everson and J. Russell George, the Treasury Inspector General for Tax Administration to this morning's hearing. I look forward to hearing each of your views on the IRS's fiscal year 2006 budget as well as issues related to the administration and enforcement of our Nation's tax code. With the April 15 tax filing deadline rapidly approaching, you can see everybody smiling about what a wonderful day that will be. As a result, we're especially looking forward to Commissioner Everson's testimony on the current state of the IRS and how the service is responding not only to taxpayers' needs but what has become popularly described as the "tax gap"; namely, what taxes should be paid and what taxes are actually paid.

We also are looking forward to the IG's perspective on the strengths and weaknesses of the IRS's capacity to effectively collect taxes.

As I understand the budget request for 2006, the IRS is making renewed efforts to reduce the tax gap through an increased investment in enforcement funding. I understand and support these efforts. Closing this gap is especially important as the Federal Government seeks to reduce the deficit and reform Social Security. I believe that those of us who pay taxes as we should bear a heavy burden when 15 percent of taxes that are owed are not collected. Consequently, I've appreciated discussions about how we can close that gap so that we can get the taxes that are actually owed and enable the government to lower the deficit that we face.

In particular, the IRS is proposing to close this gap by increasing the Nation's investment in enforcement, proposing an 8 percent increase in enforcement. Moreover, the budget proposes that no less than \$6.446 billion must be used exclusively for tax enforcement, which would result in an additional \$446.5 million in contingent funding for appropriations. The use of this budget mechanism is justified because the government collects \$4 for every \$1 spent for enforcement. I'm not convinced of the arithmetic. I am convinced, however, additional enforcement spending will result in additional collections. This is true despite the fact that the strength and weakness of our Nation's Federal income tax system is its reliance on the voluntary compliance of American taxpayers. Most Americans believe in the law and pay their taxes. Nevertheless, there will always be some that fail to comply or engage in outright fraud. This is the IRS's greatest managerial challenge and I believe the IRS should have the resources to meet that challenge.

That's why effective enforcement of the tax laws are so critically important and why I support an increase in the funding for enforcement efforts. Enforcement cannot be lax, ineffective, or uneven; otherwise, more people will be encouraged to commit fraud. We also must ensure enforcement funds are used for enforcement and not other priorities. I'm disappointed that the subcommittee does not get adequate credit under the convoluted budget scoring principles for the savings achieved through enforcement, especially since OMB has proposed the underfunding of so many other parts of our bill. If we could get credit for the additional collections coming from enforcement, we would be able to meet many of our threshold needs. However, the overall budget has been cut by 2 percent with many functions in our budget requiring cost-of-living increases which are not addressed. Housing, for example, does not get 2 percent less expensive. As a result, this budget puts us in a very difficult position, a theme that we will be reiterating in our discussions with all of the other agencies that come before us.

The primary mission of the IRS is to ensure the full and fair compliance of all taxpayers to meet their tax obligations. This is the underlying purpose of the IRS's budget. However, I'm concerned about the proposed 1 percent decrease in taxpayer service funding. The IRS needs to balance customer service with its compliance and enforcement efforts. As a result, the IRS must provide high quality and in-depth customer service to assist taxpayers, especially low-income taxpayers. I believe that most people who fail

to comply with the code do so unintentionally because of its difficulty and complexity. Active and timely guidance from the service is imperative to ensure taxpayer compliance.

Nevertheless, I remain concerned about the proposed reduction in customer service, especially since the IRS has improved its customer service and guidance over the past 2 years. I'm especially impressed over the improvement through internet, telephone, and in-person assistance. E-file options have become especially important, helping to reduce the burden of filing tax returns both for the government and the taxpayer.

Unfortunately, the biggest hurdle facing taxpayers and the IRS and all of us is the Federal Tax Code, its regulations and other guidance, which constitute more than 54,000 pages. It is too complex, too confusing, and too costly. On a daily basis, I hear complaints from small tax practitioners and businesses that the code has become unmanageable and confusing, resulting in excessive cost and administrative burdens that far exceed reasonable tax compliance. I believe it was Walt Kelly's "Pogo" who said those famous words, "We have met the enemy and he is us". This is our responsibility and, unfortunately, even with all the wisdom in the Appropriations Committee, we don't write the tax code. Nevertheless, I firmly support a comprehensive reform of the tax code based on simplicity and reasonableness. This alone would result in substantially reduced tax fraud by making the process simpler and the system far fairer for all taxpayers.

Finally, I direct concerns to an area of particular importance to me: the ongoing efforts of the IRS to modernize the IRS computer system known as Business System Modernization or BSM. The ultimate success of this system is critical to collections. Historically, the IRS has long been dependent upon antiquated computer systems to perform basic tax administration activities. As a result, Congress created a special business systems account to fund the replacement of these outdated systems. Nevertheless, the cost for BSM is fast approaching \$2 billion. The key feature of the modernization program and the customer account data engine, with acronym being CADE, is hampered by development problems and cost overruns while remaining inadequate and ineffective. For example, the report on Custodial Accounting Project, CAP, showed that it was significantly behind schedule and over budget. This system was designed to correct longstanding weaknesses in the IRS financial management systems, which account for approximately \$2 trillion in tax collections annually. Additionally, TIGTA found the IRS and CAP contractor did not adequately manage system requirements. In another example, TIGTA reported that the security audit system used to record the online activity of IRS employees through audit trails was accepted by IRS even though the required functions the IRS paid for were not operating. The bottom line is that scheduling and cost estimation have been a big problem. Almost every system is behind schedule and over cost and is delivering less functionality than originally planned.

Commissioner, your budget request is \$199 million for BSM. I'm not convinced this system works adequately, but ultimately the IT system is the heart of the entire collection and compliance system. BSM must be fixed and must be made workable to establish clearer

requirements and benchmarks for its progress. As I understand it, the system was supposed to be completed in 10 years. I don't believe anyone believes this schedule is now achievable as schedule delays and cost over-runs continue to rule—this is not the exception in this ongoing effort: schedule slippages and cost over-runs have been epidemic and, in fact, I believe the IRS is running late and is over-budget on all seven core projects related to BSM. I'm concerned BSM is becoming the 21st century version of the TSM program which was the IRS's prior modernization effort that was abandoned after 6 years and \$4 billion. TSM was a total loss. The current BSM effort began in 1998 and has already cost \$2 billion. This program, like TSM before it, raises more questions than answers.

PREPARED STATEMENT

Commissioner, I support your efforts in enforcement and closing the tax gap. I applaud your efforts but an effective BSM is critical. I'm looking forward to working with you and the IRS on these efforts. I also applaud your commitment on addressing the funding, schedule, and requirement needs of the BSM. I thank you for coming to testify today and I look forward to your testimony and the testimony of Mr. George on the many challenges confronting the IRS in the 21st century. It's now my pleasure to turn to my ranking member, Senator Murray.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

The Senate Appropriations Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development and Related Agencies will come to order. We welcome Internal Revenue Service Commissioner Mark Everson and J. Russell George, the Treasury Inspector General for Tax Administration, to this morning's hearing. I look forward to hearing each of your views on the IRS's fiscal year 2006 budget as well as issues related to the administration and enforcement of our Nation's tax code.

With the April 15 tax filing season deadline rapidly approaching, we are especially looking forward to Commissioner Everson's testimony on the current state of the IRS and how the Service is responding not only to taxpayers' needs but what has become popularly described as the "Tax Gap"; namely, what taxes should be paid and what taxes are actually paid. We also are looking forward to the IG's perspective on the strengths and weakness of the IRS's capacity to effectively collect taxes.

As I understand the budget request for fiscal year 2006, the IRS is making renewed efforts to reduce the tax gap through an increased investment in enforcement funding. I understand and support these efforts. Closing this gap is especially important as the Federal Government seeks to reduce the deficit and reform social security.

In particular, the IRS is proposing to close this gap by increasing the Nation's investment in enforcement by proposing an 8 percent increase in enforcement. Moreover, the budget proposes that no less than \$6.446 billion be used exclusively for tax enforcement which would result in an additional \$446.5 billion in contingent funding for appropriations. The use of this budget mechanism is justified because the government collects \$4 for every \$1 dollar spent for enforcement. While I am not convinced of the arithmetic, I am convinced that additional enforcement spending will result in additional collections to a point. This is true despite the fact that the strength and weakness of our Nation's Federal income tax system is its reliance on the voluntary compliance of American taxpayers. Most Americans believe in the law and pay their taxes. Nevertheless, there will always be some that fail to comply or engage in outright fraud. This is the IRS's greatest managerial challenge and the IRS should have the resources.

That is why effective enforcement of our tax laws is so critically important, and why I support an increase in the funding of enforcement efforts. Enforcement cannot

be lax, ineffective, or uneven; otherwise more people will be encouraged to commit fraud. We must ensure enforcement funds are used for enforcement and not other priorities. I am disappointed that the subcommittee does not get adequate credit and savings for its investment in enforcement, especially since the administration has proposed underfunding of so many other parts of our bill.

The primary mission of the IRS is to ensure the full and fair compliance of all U.S. taxpayers with their tax obligations. These efforts cannot through enforcement and compliance solely. Consequently, I am very troubled by the proposed 1 percent decrease in Taxpayer Service funding. The IRS needs to balance customer service with its compliance and enforcement efforts.

As a result, the IRS must provide high quality and in-depth customer service to assist taxpayers, especially low-income taxpayers. I believe that most people who fail to comply with the code do so unintentionally because of its difficulty and complexity. Accurate and timely guidance from the Service is imperative to ensuring taxpayer compliance.

Nevertheless, while I remain concerned about the proposed reductions in customer service, the IRS has improved its customer service and guidance over the past few years. I especially am impressed over improvements through the internet, telephone and in-person assistance. E-file options have become especially important, helping to reduce the burden of filing tax returns for both the government and the taxpayer.

Unfortunately, the biggest hurdle facing taxpayers and the IRS is the Federal tax code, its regulations and other guidance, which has morphed to more than 54,000 pages—this is too complex, confusing, and costly. On an almost daily basis, I hear complaints from small tax practitioners and businesses that the Code has become unmanageable and confusing, resulting in excessive cost and administrative burdens that far exceed reasonable tax compliance. I firmly support a comprehensive reform of the tax code that is founded in simplicity and reasonableness. This alone would result in substantially reduced tax fraud by making the process simpler and the system far fairer for all taxpayers.

Finally, I'd like to direct my concerns to an area of particular importance to me: the ongoing efforts of the IRS to modernize the IRS computer systems, known as Business Systems Modernization (BSM). The ultimate success of this system is critical to collections.

Historically, the IRS has been long dependent upon antiquated computer systems to perform basic tax administration activities. As a result, Congress created a special business systems modernization account to fund the replacement of these outdated systems. Nevertheless, the cost for the BSM program is fast approaching \$2 billion. The key feature of the modernization program, Customer Account Data Engine (CADE), is hampered by delays in development and cost overruns while remaining inadequate and ineffective.

For example, TIGTA's report on the Custodial Accounting Project (CAP) showed that it was significantly behind schedule and over budget. This system was designed to correct longstanding weaknesses in the IRS financial management systems systems, which account for approximately \$2 trillion in tax collections annually. Additionally, TIGTA found the IRS and the CAP contractor did not adequately manage system requirements. In another example, TIGTA reported that the system (Security Audit and Analysis System) used to record the online activity of IRS employees through audit trails which was accepted by IRS even though the required functions IRS paid for were not operating.

The bottom line is that scheduling and cost estimation have been a very big problem for IRS. Almost every system is behind schedule, over cost, and is delivering less functionality than originally planned.

Mr. Commissioner, your budget request seeks \$199 million for BSM. I am not convinced this system works, but ultimately the IT system is the heart of the entire collection and compliance system. BSM must be fixed. IRS needs to establish clear requirements and benchmarks for progress. As I understand it, this system was supposed to be completed in 10 years. I do not believe that anyone believes this schedule is now achievable and schedule delays and cost overruns continue to be the rule—not the exception—to this ongoing effort. These schedule slippages and cost-overruns have been epidemic. In fact, I believe the IRS is running late and is over budget on all seven core projects related to BSM.

I am very concerned that BSM is becoming the 21st century version of the Tax Systems Modernization (TSM) program, which was the IRS's prior modernization effort that was abandoned after consuming 6 years and \$4 billion in Federal tax dollars. That effort was a complete loss.

The current BSM effort began in 1998 and has already cost almost \$2 billion. This program, like TSM before it, raises more questions than answers.

Commissioner Everson, I support your efforts in enforcement and closing the tax gap. I applaud your efforts. However, an effective BSM is critical to these efforts. I am looking forward to working with you on these efforts. However, I also am looking to your commitment on addressing the funding, schedule and requirement needs of the BSM.

I thank you again coming to testify before the subcommittee this morning. I look forward to your testimony and the testimony of Mr. George on the many challenges confronting the IRS in the 21st century.

I now turn to my Ranking Member, Senator Murray.

STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Thank you very much. Mr. Chairman, I want to welcome back IRS Commissioner Everson and I want to welcome Russell George who is our new Treasury Inspector General for Tax Administration testifying before this subcommittee for the first time. In 8 days, millions of Americans who play by the rules will go to the post office to file their tax returns. These honest taxpayers should be appalled by the IRS's findings released last week that reveal that the agency will fail to collect between a quarter and a third of a trillion dollars it's owed this year because of tax cheats. That figure is the equivalent of the amount we spent on the entire Department of Defense a couple of years ago. It represents roughly \$1 out of every \$5 that is owed by American taxpayers.

According to the IRS, the majority of these unpaid taxes take the form of unreported income by businesses, partnerships, estates, and so-called S corporations. Thankfully, the IRS now recognizes they need to get serious with tax cheats. The agency is asking for almost an 8 percent increase for tax law enforcement and a budget that is extremely frugal when it comes to other areas of domestic spending.

While some Senators have expressed concern that boosting IRS's enforcement budget could cost the agency to return to its troubled past when IRS agents used excessive force to harass taxpayers, I want to believe the agency has learned from its past mistakes and would use this funding boost to go after the real criminals. But what troubles me about this proposed IRS budget is the lack of balance between the desire to boost enforcement and the need to fund critical services to taxpayers. A detailed review of the budget request for the IRS shows that buried within the overall funding increase for the agency is almost a quarter billion dollars in anticipated cuts in current activities. Most disappointing is that the majority of those cuts come in the form of cuts in direct taxpayer services. Proposals to achieve these cuts include closing as many as one out of every four taxpayer assistance centers in the United States. The IRS wants to eliminate phone filing, a tool currently used by more than 5 million individuals and business every year. Other proposed cuts in taxpayer services include shortening phone service hours, discontinuing tax law assistance through the internet, limiting distribution of some outreach publications and face-to-face contacts with practitioners, and eliminating phone-routing sites and staffing.

In last year's hearing, the commissioner shared with us his motto that "service plus enforcement equals compliance". That motto is also prominently featured in his testimony this year. However, I fear a review of the budget request might indicate the motto should more appropriately be "only enforcement yields compliance so let's

cut services to pay for it". I believe that service to taxpayers is still a critical mission of the IRS and I know I'm not alone in believing this. While a recent IRS Oversight Board Taxpayer Attitude Survey found that 62 percent of taxpayers thought the IRS should get more money for enforcement, 64 percent of taxpayers said the IRS should get more money to assist taxpayers on the phone and in person. But it's precisely those types of services that the IRS wants to cut.

PREPARED STATEMENT

Now, while she's not appearing before us today, I have reviewed the submitted testimony of the Taxpayer Advocate, Nina Olson. The Office of the Taxpayer Advocate was created by Congress so there would be staffed professionals with access to the commissioner to constantly look out for the interests of individual taxpayers as the IRS develops his processes and procedures. The Advocate is also charged with assisting taxpayers in resolving problems with the IRS and communicating the interests of taxpayers directly to Congress. According to Ms. Olson, closing taxpayer assistance centers at this time will irrevocably harm taxpayers. She points out that the IRS has not offered alternatives to the face-to-face interaction of these centers. It seems the only face-to-face alternative left is for affected taxpayers to drive much farther to another center. Especially because the IRS is moving so quickly on these new proposals, I would like to use a portion of today's hearing to discuss in detail precisely what the impact will be on individual taxpayers resulting from IRS-proposed cuts, as called for in the administration's budget. The tax code is complicated enough without our cutting back on the level of assistance our citizens have come to expect as they seek to file the taxes accurately and on time. Thank you very much, Mr. Chairman.

[The statement follows:]

PREPARED STATEMENT OF SENATOR PATTY MURRAY

Thank you, Mr. Chairman.

I want to welcome back IRS Commissioner Everson. I also want to welcome Russell George, our new Treasury Inspector General for Tax Administration, who is testifying before us for the first time.

In 8 days, millions of Americans who play by the rules will go to the post office to file their tax returns. These honest taxpayers should be appalled by the IRS's findings, released last week, that reveal that the agency will fail to collect between a quarter and a third of a trillion dollars it is owed this year because of tax cheats.

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overall funding increase for the agency is almost a quarter billion dollars in anticipated cuts in current activities.

Most disappointing is that the majority of those cuts come in the form of cuts in direct taxpayer services. Proposals to achieve these cuts include closing as many as one out of every four Taxpayer Assistance Centers in the United States.

The IRS wants to eliminate phone filing, a tool currently used by more than 5 million individuals and businesses every year. Other proposed cuts in taxpayer services include:

- shortening phone service hours;
- discontinuing tax law assistance through the Internet;
- limiting distribution of some outreach publications and face-to-face contact with practitioners; and,
- eliminating phone-routing sites and staffing.

In last year's hearing, the Commissioner shared with us his motto that, "Service Plus Enforcement Equals Compliance." That motto is also prominently featured in his testimony this year. However, I fear a review of the IRS's budget request might indicate that the motto should more appropriately be: "Only Enforcement Yields Compliance—So Let's Cut Services to Pay For It."

I believe that service to taxpayers is still a critical mission of the IRS—and I know I am not alone in believing this. While a recent IRS Oversight Board Taxpayer Attitude Survey found that 62 percent of taxpayers thought that the IRS should get more money for enforcement, 64 percent of taxpayers said that the IRS should get more money to assist taxpayers on the phone and in person.

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The tax code is complicated enough without our cutting back on the level of assistance our citizens have come to expect as they seek to file their taxes accurately and on time.

Thank you, Mr. Chairman.

Senator BOND. Thank you very much, Senator Murray. Senator Dorgan, do you have a brief opening statement?

STATEMENT OF SENATOR BYRON L. DORGAN

Senator DORGAN. Mr. Chairman, first of all, thank you for holding this hearing. I think recent announcements about the size of the tax gap should cause all of us great concern. It's something I want to visit with the IRS officials about. Also, the issues of taxpayer assistance, I assume my colleague was just discussing that as I walked in. Let me defer and hear from the commissioner and then I will ask some questions.

Senator BOND. Thank you very much, Senator Dorgan, and Commissioner Everson, we're making your full statement part of the record and I believe you have provided a summary. We invite you to give that now. Thank you.

STATEMENT OF MARK W. EVERSON

Mr. EVERSON. Chairman Bond, Ranking Member Murray, Senator Dorgan, I'm happy to be here. I appreciate the opportunity to testify on the President's request.

The President's 2006 request for the IRS is crafted to continue the necessary rebuilding of our enforcement capabilities, and it maintains a stable commitment to our important IT modernization program. Enforcement and modernization were categorized earlier this year by the GAO as high risk areas of government-wide importance. The 2006 budget request calls for a modest amount of belt-tightening in taxpayer services. The cut to services of 1 percent is consistent with the requests for domestic discretionary programs other than those associated with homeland security. In a report issued last year, the GAO stated, "Taxpayer services are much improved, raising a question about the appropriate balance to strike between investing in further service improvements and enforcement. At the same time, the use of IRS's walk-in assistance sites is declining. The improvements in telephone service, increased web site use, and the availability of volunteer sites raise a question about whether the IRS should continue to operate as many walk-in sites. Reconsidering the level and types of services is an option—but not a recommendation—to be considered by IRS management and the Congress."

[The information follows:]

GAO'S COMMENTS ON WALK-IN ASSISTANCE

"... the use of IRS's walk-in assistance sites is declining. The improvements in telephone service, increased Web site use, and the availability of volunteer sites raise a question about whether IRS should continue to operate as many walk-in sites. Reconsidering the level and types of service is an option—but not a recommendation—to be considered by IRS management and the Congress."—Statement of James R. White, Director, Tax Issues.

PRESIDENT'S BUDGET REQUEST

The President's request for the IRS adopts just this approach. I am comfortable with this request and support it wholeheartedly. I want to stress to you, Senator Murray, that I believe that we will provide good services. If enacted at the requested level without constraining language, we will continue to do our job on the service front.

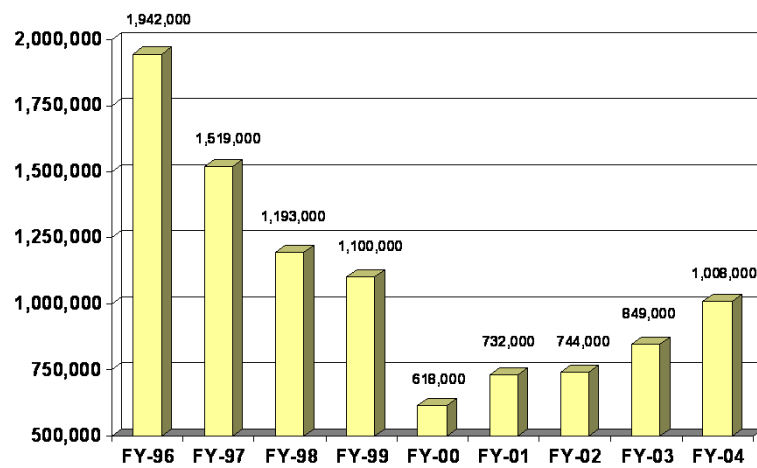
The budget will hold Business System Modernization funding steady at substantially the same level as 2005. In terms of modernizing our big computer systems at the IRS, after years of cost overruns and missed delivery dates, we've finally turned the corner. In the past 9 months, two important systems have come on-line. We have a new financial system to help better manage the agency, and more importantly, this filing season the IRS has already processed over 1 million 1040EZ tax returns using the first new processing system in 40 years. The 2006 budget continues investment in three critical areas: further work on return processing, collections, and electronic filing.

ENFORCEMENT FUNDING

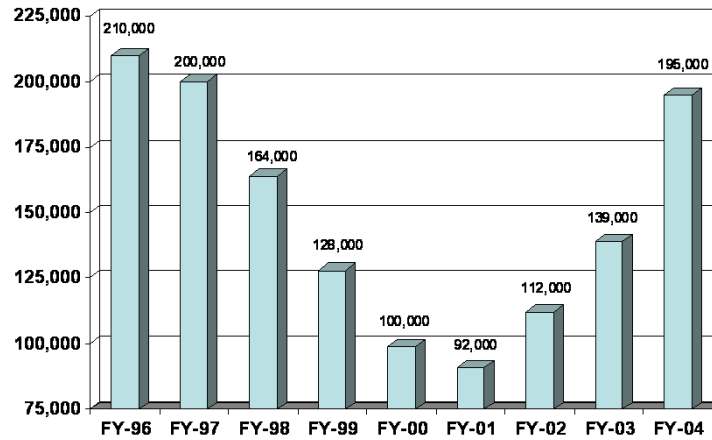
Let me turn to the need for more enforcement funding.

As you mentioned, 2 weeks ago we announced that the gross tax gap—that's the difference between what taxpayers should pay and what they actually pay on a timely basis—exceeds \$300 billion per year. Average Americans pay their taxes honestly and accurately and have every right to be confident that when they do so, neighbors and competitors are doing the same. We've taken some important steps to bolster this confidence.

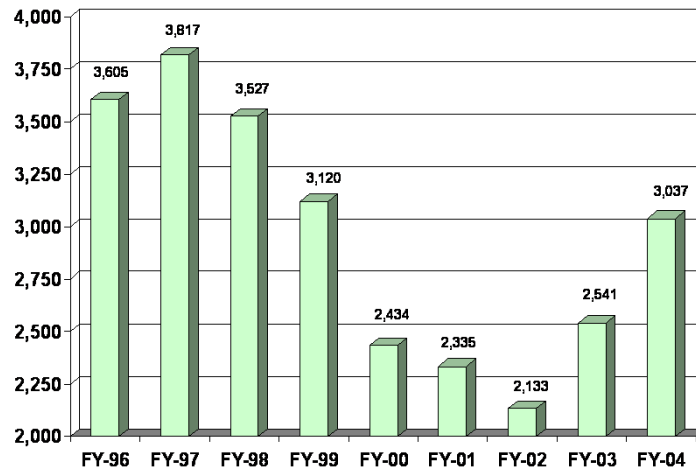
Individual Audits



High Income Audits



Criminal Prosecutions Recommended



AUDIT RATES

We have ramped up our audits of individuals. You can see they've gone from 618,000, 4 years ago to over 1 million last year, and they will go up again in 2005. We've done this particularly for

high-income individuals. You can see they've doubled from \$192,000, pardon me, \$92,000 to \$195,000 over the same period, and they're going to go up again in a double-digit increase for 2005.

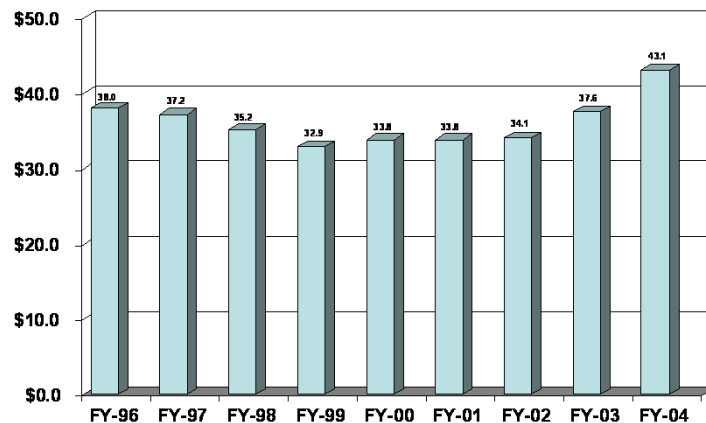
We are doing more with corporations and we're doing more with criminal investigations. This next chart shows the referrals we've made to the Justice Department, which have come up significantly in the last several years. We recently announced collections of over \$3.2 billion in the settlement initiative for Son of Boss, a particularly abusive shelter.

The 2006 budget calls for nearly 8 percent increase for enforcement. This will enable us to expand our efforts over strategic compliance by corporations, individual taxpayers, and other contributors to the tax gap; ensure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law; detect and deter domestic and off-shore based tax and financial criminal activity; and, deter abuse within tax-exempt and governmental entities and misuse of such entities by third parties for tax evasion or other unintended purposes. It's a very important subject that was the subject of an inquiry by the Finance Committee just 2 days ago.

These investments will pay for themselves several times over. The IRS yields more than \$4 in direct revenue from its enforcement efforts for the money invested in its total budget, including our service and outreach activities. That's to say, the \$43 billion in enforcement revenue compares to the \$10.2 billion we are appropriated. The \$10.2 billion includes everything we do, not just the enforcement, but the processing and the outreach, all those activities.

IRS Enforcement Revenue

Dollars in Billions



ENFORCEMENT REVENUE

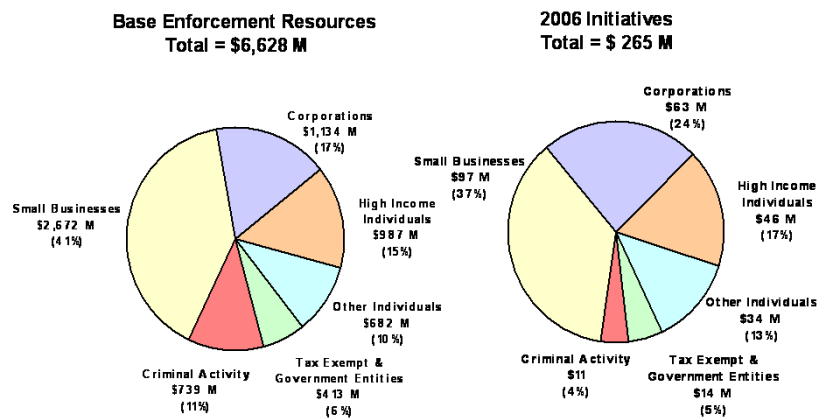
Now, last year, the \$43 billion, that represented a 15 percent increase from the year before, so you can see that is coming up. That is a result of all the other things you saw. I want to emphasize that these figures exclude the positive impact on compliance that occurs when someone learns in a casual conversation that their neighbor has been audited and then thinks twice about fudging his or her own return. So this is just the direct return.

Let me make one additional point that the chairman has touched upon about enforcement.

The President's budget calls for the Congress to adjust its 302(a) allocation to the Appropriations Committee up to \$446 million, once the base level of \$6.4 billion for IRS enforcement is fully funded and restricted for use only on IRS enforcement. The \$446 million consists of \$265 million for new enforcement initiatives and \$182 million for maintaining current enforcement levels.

Allocation of Enforcement Resources

Dollars in Millions



BUDGET RESOLUTION

The Senate Budget Resolution contains language which would allow this proposal to proceed. The House Resolution does not. I urge you to see the Senate position maintained during the conference. This proposal will allow the IRS to devote resources where needed: in enforcement. Thank you.

[The statement follows:]

PREPARED STATEMENT OF MARK W. EVERSON

INTRODUCTION

Chairman Bond, Ranking Member Murray, and members of the subcommittee, thank you for the opportunity to testify today on the fiscal year 2006 budget request for the Internal Revenue Service.

Our working equation at the IRS is service plus enforcement equals compliance. The better we serve the taxpayer, and the better we enforce the law, the more likely the taxpayer will pay the taxes he or she owes.

This is not an issue of service OR enforcement, but service AND enforcement. As you know, IRS service lagged in the 1990's. In response, we took important and necessary steps to upgrade service—we significantly improved the answering of taxpayer telephone inquiries and electronic filing to name just a couple areas.

Unfortunately, improvement in service coincided with a drop in enforcement of the tax law. After 1996, the number of IRS revenue agents, officers, and criminal investigators dropped by over 25 percent.

TAX GAP

We currently have a serious tax gap—the difference between what taxpayers are supposed to pay and what is actually paid—in this country. The results of the National Research Program indicate the Nation's tax gap increased slightly to between \$312 billion and \$353 billion in tax year 2001. This compares to the old tax gap estimate for 2001 of \$311 billion based on earlier studies. By our best estimates, we lose almost \$300 billion each year due to non-filing, underreporting, and underpayment, although this number reflects the fact that we do eventually recover about \$55 billion of the gross tax gap.

We launched the National Research Program (NRP) in 2001. We designed the NRP to measure individual taxpayer reporting compliance for tax year 2001. Over the course of the next 3 years, we randomly selected about 46,000 returns for review and examination. We largely completed these audits by the fall of 2004. To gather statistically valid data, the return selection process for the NRP included an over-sampling of high income returns. This enables IRS researchers to draw valid conclusions about important sub-categories of taxpayers.

For instance, slightly more than 6 percent of individual taxpayers filed Schedule C as sole proprietors in 2001. These taxpayers reflect a wide range of economic activity. To draw valid conclusions on Schedule C filers, the NRP examined about 21,000 individuals who filed a Schedule C, slightly less than 46 percent of the total sample.

The current data from the NRP are preliminary, so the results are shown as ranges. As refinements are made to the tax gap analysis, some of these estimates may change. It is unlikely, but possible, that the final estimates of the tax gap will fall outside of the established range.

The tax gap figure does not include taxes that should have been paid on income from the illegal sector of the economy.

For Tax Year 2001, all taxpayers paid \$1.77 trillion on time, a figure that represents from 83.4 percent to 85 percent of the total amount due. The 2001 tax gap, the difference between taxes owed and taxes paid on time is from \$312 billion to \$353 billion for all types of taxes.

Overall, the noncompliance rate is from 15 percent to 16.6 percent of the true tax liability. The old estimate, derived from compliance data for Tax Year 1988 and earlier, was 14.9 percent.

Late payments and other IRS enforcement and compliance efforts, including taxpayer audits and collection activities (payment arrangements, liens, levies and other legal actions) recover some of the Tax Gap. For Tax Year 2001, we expect eventually to collect an additional \$55 billion of the tax gap, reducing the net amount of the tax gap to between \$257 billion and \$298 billion.

Among the areas where taxpayer compliance appears to have worsened are:

- Reporting of net income from flow-through entities, such as partnerships and S corporations;
- Reporting of proprietor income and expenses, such as gross receipts, bad debts and vehicle expenses; and,
- Reporting of various types of deductions.

Among the areas where compliance seems to have improved is the reporting of farm income.

Overall, compliance is highest where there is information reporting and/or withholding. For example, most wages, salaries and tip compensation are reported by employers to the IRS through Form W-2. Preliminary findings from the NRP indi-

cate that less than 1.5 percent of this type of income is misreported on individual returns.

IRS researchers anticipate identifying other specific areas of deterioration and improvement in the coming months as they complete the detailed analysis of the study's data.

Today I will give you an update on what we've accomplished over the past year, speaking in particular about enforcement, the area where our challenges remain the greatest. We must restore the balance between service and enforcement, but that will not come at the expense of taxpayer service. In recent years, we have begun to attack the decline in enforcement by revitalizing our investigations, audits and prosecutions against those who do not pay their taxes. The President's fiscal year 2006 budget—if approved by Congress—will help with our efforts to boost enforcement while maintaining our levels of service. This budget includes \$265 million for initiatives aimed at enhancing the enforcement of tax laws.

Before I talk specifically about our fiscal year 2006 budget request, let me first talk about our progress in service. By service, we mean helping people understand their tax obligations and making it easier for them to participate in the tax system.

Electronic filing continues to grow. Last year Americans filed over 61 million electronic returns. This year we expect that over half of all individual returns will be e-filed. Thus, it appears that individuals who file on paper will soon be in the minority. We take every opportunity we can to proclaim the benefits of electronic filing, including a reduction in processing errors and cost savings for taxpayers and the IRS. E-filing is fast, convenient and gets your refund to you in half the time of paper returns.

Use of our website, IRS.gov, is also up sharply. During the filing season, it is one of the busiest websites in the world. We average more than 1 million visits a day. Just to give you a frame of reference: one major search engine reported that in a recent week we were surpassed only by Paris Hilton, Clay Aiken, Pamela Anderson, Britney Spears, and a poker game. During the past year, we have also rolled out important new on-line services to tax professionals to help them better serve their clients.

In terms of modernizing our big computer systems at the IRS, we've finally turned the corner. Since March 2004, two important systems have started operating. First, we have a new financial system to help better manage the agency. And secondly, and more importantly, for the first time in 40 years, the IRS is processing tax returns on a new computer system. We started with 1040EZ returns and have processed over 1 million as of April 4. This is a big step forward in our effort to modernize our antiquated computer systems.

CONTINUING SERVICE AND INCREASING ENFORCEMENT

We are quite aware of the need to operate efficiently, consolidate operations and drive down costs wherever we can. In today's fiscal environment, we recognize that resources are tight. Nevertheless, we are determined to do all we can to improve service and modernize the IRS. In the last several years, we have begun to arrest the decline in enforcement and stabilize IRS enforcement staffing; now 73 percent of taxpayers completely agree that it is every American's duty to pay their fair share of taxes, up from 68 percent in 2003. A 2004 IRS Oversight Board commissioned NOP World study revealed 79 percent of taxpayers believe it is very important for the IRS to enforce compliance from high-income individuals and 85 percent believe it is very important for the IRS to enforce compliance from corporations. But in order to continue to reverse the downward trend of compliance, we must continue to use our resources wisely.

We are working aggressively to improve productivity and achieve cost savings, which we will apply to other priority areas, such as enforcement. The fiscal year 2006 budget reduction initiatives focus mainly on targeted reductions in assistance, outreach, and processing program areas. Reductions will also be achieved through improved efficiencies and re-engineering of business processes in key program areas in accounts management, submission processing, media and publications, field assistance, and outreach and education. Approximately 65 percent of these reductions will occur in assistance, 20 percent in outreach and 15 percent in processing. We will minimize the impact on taxpayers by providing alternative means to obtain service, wherever possible. Our budget estimates all these taxpayer service re-engineering initiatives will yield \$134 million in savings we can reinvest in other program areas. The reductions represent a balanced approach in program delivery and service to taxpayers to enable them to meet their tax obligations.

We estimate savings of \$75 million to \$95 million from additional efficiencies in our field assistance, accounts management and toll-free telephone operations. We

will achieve these savings, in part, because of our recent consolidation our Customer Accounts Service organizations and revamping our business processes. For example, due to the steady decline in taxpayers corresponding with us about their accounts, we will need fewer resources to manage these accounts. We are also adjusting the hours of our toll-free telephone operations from 15 to 12 hours daily, Monday through Friday in the local times zones, beginning in 2005. We expect minimal impact to our level of service for taxpayers who call us. Another portion of these savings will come from reducing the number of walk-in sites. In recent years, the number of taxpayers walking into a Taxpayer Assistance Center (TAC) site for assistance has decreased from a high of nearly 10 million contacts in fiscal year 2000 to about 7.7 million contacts in fiscal year 2004. This trend reflects the increased availability and quality of services that do not require travel or waiting in line. Examples include improved access to IRS telephone service, the increasing availability of volunteer assistance, and the many services now available through IRS.gov, such as "Free File" and "Where's My Refund." In addition, the ability to download forms online has also contributed to the decline in the number of customers walking into a TAC. We have also continued to improve our telephone service for taxpayers who call the IRS with questions. The use of other alternatives, such as volunteer return assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly (TCE) sites, has steadily increased while the number of TAC contacts decreased. In fiscal year 1999, for example, VITA sites filed almost 584,000 returns, and TCE sites filed 446,000 returns. In the next 5 years, the numbers of returns filed through these sites increased 88 percent, reaching 976,000 VITA returns and 958,000 TCE returns in fiscal year 2004.

Because of these other options, fewer taxpayers need to travel to an IRS office to get the services they need. There are currently about 400 TAC sites across the country which are serviced by approximately 2,300 TAC employees. We believe that adjusting the TAC sites to more closely align to this decreased walk-in volume will yield staffing and building cost savings of \$45 million to \$55 million of the \$75 million to \$95 million in savings, and allow us the flexibility to improve efficiencies and concentrate more on front-line enforcement.

We have developed a criteria model that measures the impact on taxpayers across the country. The criteria include: location, employee cost, facilities cost, workload, and demographic measurements. In anticipation of the closing of approximately 70 TACs and their employees, we have requested authority to offer early-outs and buy-outs to all eligible IRS TAC personnel. We expect to have further announcements in the near future.

In addition to reducing the number of TAC sites, we will save \$20 million to \$31 million in outreach programs through reductions in printing and postage and additional efficiencies in our outreach organizations. For example, we will save more money in printing and postage as taxpayers shift to e-filing, and as we eliminate redundant services and publications.

We will save another \$17 million to \$23 million by retiring Telefile, implementing program enhancements in the processing of employment tax returns, and re-engineering processes in Submission Processing. We will redirect taxpayers who previously used Telefile to e-file alternatives, such as Free File, that are available through IRS.gov so we maintain an acceptable level of service.

Though we are re-engineering how we provide service, we will continually strive to improve service to taxpayers. Having stated this, I must address the fundamental issue of enforcement.

While the President's Budget Request to Congress would increase IRS enforcement activities by 7.8 percent, given the current budgetary constraints, we responsibly proposed to reduce spending in other areas throughout the Service. We are confronted with difficult choices.

Average Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four service-wide enforcement priorities.

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

—In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year—double the number from 2000.

—Overall, audits for individuals exceeded the 1 million mark last year, up from 618,000 4 years earlier.

—In 2004, the number of audits of the largest businesses—those with assets of \$10 million or more—finally increased after years of decline.

The centerpiece of our enforcement strategy is combating abusive tax shelters, both for corporations and high-income individuals. I will touch upon two important initiatives of the past 12 months.

We have continued our program of settlement offers for those who entered into abusive transactions in the past but would like to get their problems behind them. Last May, we made a settlement offer regarding the Son of Boss tax shelter, a particularly abusive transaction used by wealthy individuals to eliminate taxes on large gains, often in the tens of millions of dollars. In this program, for the first time, the IRS required a total concession by the taxpayer of artificial losses claimed. I am pleased with the response to the offer. So far, \$3.2 billion in taxes, interest and penalties have been collected from the 1,165 taxpayers who are participating in the settlement initiative. The typical taxpayer payment was almost \$1 million, with 18 taxpayers paying more than \$20 million each and one paying over \$100 million. Processing of individual settlements continues.

Based on disclosures we have received from promoter investigations and from investor lists from Justice Department litigation, we have determined that just over 1,800 people participated in Son of Boss. When the project concludes in the coming months, we expect the collected figure should top \$3.5 billion.

In February 2005, we announced a second important settlement initiative—this one involving executive stock options. This abusive tax transaction involved the transfer of stock options or restricted stock to family-controlled entities. These deals were done for the personal benefit of executives, sometimes at the expense of public shareholders. This shelter was not just a matter of tax avoidance but, in some instances, raises basic questions about corporate governance. Again, the settlement offer is a tough one: full payment of the taxes plus a penalty.

A noteworthy point about the stock option settlement offer is that our actions in this matter were closely coordinated with the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

Our settlement initiatives and increased audits have sent a signal to taxpayers: the playing field is no longer as lopsided as it once was. Non-compliant taxpayers might have to pay the entire tax, interest, and a stiff penalty. A taxpayer might have to wrestle with questions like “how much am I going to have to pay the lawyers and expert witnesses to litigate this thing?” Moreover, going to court is a public matter. Damage to one’s reputation is a potential factor. Many wealthy individuals, otherwise seen as community leaders, may not want to be identified as paying less than their fair share in taxes.

Another example of cooperation in the battle against abusive shelters is in the international arena. A year ago, I announced the formation of what has come to be known as the Joint International Tax Shelter Information Centre. Since last Labor Day, we have had an operational task force of personnel from Australia, Canada, the United Kingdom, and the United States working together on-site here in Washington. We are exchanging information about specific abusive transactions. Results to date are promising. Thus far, we have uncovered a number of transactions which, but for the Centre, we would have unraveled only over a number of years, if ever. It makes sense that we continue to work with other countries because, in this increasingly global world, we are up against what is, in essence, a reinforcing commercial network of largely stateless accounting firms, law firms, investment banks, and brokerage houses.

The government stepped up its use of civil injunctions in 2001 to prohibit promoters from selling illegal tax schemes on the Internet, at seminars or through other means. Currently the courts have issued injunctions against 99 abusive scheme promoters—81 permanent injunctions and 18 preliminary injunctions. They have issued injunctions against 17 abusive return preparers—all permanent injunctions. And an additional 49 suits have been filed by Justice seeking injunction action—28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer’s name while retaining control;
- Misusing “corporation sole” laws to establish phony religious organizations;
- Using frivolous “Section 861” arguments to evade employment taxes;
- Claiming personal housing and living expenses as business expenses;
- Filing tax returns reporting “zero income”; and,
- Misusing the Disabled Access Credit.

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice; and individual examinations are being conducted on thousands

of scheme participants. Most of the investigations and examinations are being conducted by the IRS Small Business/Self-Employed (SB/SE) Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law.

Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners. The vast majority of practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. The IRS standards set forth rules governing what does and does not qualify as an independent opinion about a tax shelter.

Last year, the government won a series of court opinions on privilege. The cases established that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted the American Jobs Creation Act. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement objective is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity.

Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters—both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But, we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax-exempt and government entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, certain credit counseling agencies. Increasingly, it appears that some credit counseling organizations have moved from their original purposes, that is, to counsel and educate troubled debtors, to inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding their insiders by negotiating service contracts with for-profit entities owned by related parties. Many newer organizations appear to have been created as a result of promoter activity.

Some shelter promoters join with tax-exempt organizations to create abusive shelters. The organization receives a large fee from the taxpayer who is taking advantage of its tax-free status. That is an unintended abuse of the tax exemption that our Nation bestows upon charities.

It is heartening to see leading members of the nonprofit community taking steps to address abuses. I particularly want to salute the Independent Sector—which recently delivered a constructive report to the Senate Finance Committee. The report states that “government should ensure effective enforcement of the law” and calls for tougher rules for charities and foundations. The report calls for stronger action by the IRS to hold accountable charities that do not supply accurate and timely public information. I encourage the accounting, legal, and business communities to be as enthusiastic about confronting abuses and the erosion of professional ethics as the nonprofit community. An interesting point to note is that the report supports mandatory electronic filing of all tax returns for nonprofits.

The threat to the integrity of our Nation's charities is real and growing. At the IRS, we take it very seriously. We are augmenting our resources in the nonprofit area. By the end of September, we will have increased the number of our personnel who audit tax-exempt organizations by over 30 percent from 2 years earlier. If we do not act expeditiously, there is a risk that Americans will lose faith in our Nation's charitable organizations. If that happens, Americans will stop giving and those in need will suffer.

As we move forward with these priorities, we will leverage our success to achieve greater results within our fiscal year 2006 budget request.

BUDGET RESTRUCTURE

To facilitate full alignment and integration of the Service's goals and measures with its resources, we are proposing to restructure our budget beginning in fiscal year 2006. These changes will facilitate a more accurate assessment of the overall value of IRS programs, simplify the full costing of programs, and allow the IRS to demonstrate incremental increases in an initiative's effectiveness based on the level of funding received.

In addition, this new budget structure will enable us to manage activities more effectively. The normal processing of tax returns generally proceeds from pre-filing activities to filing activities, and finally to compliance activities, should they prove necessary. Although these activities are interrelated, we currently distribute their resources among three appropriations, with unevenly distributed support costs. This system makes it difficult to manage, track, and report the full cost of a given Taxpayer Service or Enforcement program.

This new budget structure will enable us to prepare a true performance-based budget by providing the capability to integrate operational and support costs into one appropriation, thereby allowing us to cost budget activities and programs fully for the first time. The new structure will also facilitate the full incorporation of performance measures into the budget, as the measures could be tied to funds in one appropriation rather than a series of program activities dispersed across multiple appropriations. The proposed new budget structure will allow stakeholders to assess more accurately the overall value of IRS programs, and make program reviews, such as the Office of Management and Budget's Program Assessment Rating Tool (PART), more effective, thus providing greater accountability and results-oriented management focus.

The proposed budget structure combines the three major appropriations accounts—Processing, Assistance and Management (PAM); Tax Law Enforcement (TLE); and Information Systems (ISY)—into one appropriation called Tax Administration and Operations (TAO).

The Taxpayer Service and Enforcement programs of the TAO appropriation are divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. Full funding for each activity will be reflected in the budget, along with key performance measures. As we continue to move toward the development and implementation of this new structure, we will refine these program areas and the associated resource distributions to provide more accurate costing.

Let me now provide more details on the budget request for the IRS.

PRESIDENT'S FISCAL YEAR 2006 BUDGET SEEKS INCREASE IN ENFORCEMENT

The President's fiscal year 2006 budget requests \$10.7 billion for the IRS, a 4.3 percent increase over the fiscal year 2005 enacted level. This request represents a 1 percent decrease in Taxpayer Service and a 2 percent decrease in Business Systems Modernization (BSM), but an 8 percent increase in enforcement.

This budget includes \$265 million for initiatives aimed at enhancing the enforcement of tax laws. This request is above the increases to fund the pay raise and other cost adjustments (\$182 million), for a total of \$446 million for new enforcement investments and cost increases. It is important the Congress fully fund these cost increases and new enforcement investments. The President's budget proposal to fund them as contingent appropriations reflects the importance of this investment to the administration.

To ensure full funding of the new enforcement investments, the budget proposes to employ a budget enforcement mechanism that allows for an adjustment by the Budget Committees to the section 302(a) allocation to the Appropriations Committees found in the concurrent resolution on the budget. In addition, the administration will also seek to establish statutory spending limits, as defined by section 251 of the Balanced Budget and Emergency Deficit Control Act of 1985, and to adjust

them for this purpose. To ensure full funding of the cost increases, either of these adjustments would only be permissible if the Congress funds the base level for IRS enforcement at \$6.4 million and restricts the use of the funds to the specified purpose. The maximum allowable adjustment to the 302(a) allocation and/or the statutory spending limit would be \$446 million for 2006, bringing the total enforcement level in the IRS to \$6.9 million.

We will use the additional funds for enforcement in several key ways to combat the tax gap. Combating tax non-compliance is a top priority for us. Americans deserve to feel confident that when they pay their taxes, their neighbors and competitors are doing the same. These investments will yield substantial results.

The IRS yields more than \$4 in direct revenue from its enforcement efforts for every \$1 invested in its total budget. In fiscal year 2004, we brought in a record \$43.1 billion in enforcement revenue—an increase of \$5.5 billion from the year before, or 15 percent. Beyond the direct revenues generated by increasing audits, collection, and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

The nearly 8 percent increase for enforcement activities in the administration's 2006 IRS budget request will increase audits of corporations and high-income individuals as well as expand collection and criminal investigation efforts.

DETAILED BUDGET SUMMARY

Our fiscal year 2006 request of \$10.7 billion includes a transfer from the Justice Department of \$53.913 million and 329 FTE for our portion of the Interagency Crime and Drug Enforcement (ICDE) appropriation, \$277.6 million for a 2.3 percent pay raise and non-labor inflationary costs, and \$264.6 million for initiatives aimed at enhancing our enforcement efforts. This request also includes a \$22 million rent reduction to result from consolidation of space, and the \$134.1 million reduction to taxpayer service activities that we will responsibly leverage through productivity improvements and program reengineering, as previously discussed. We will take a balanced approach to these targeted reductions.

In addition to the taxpayer service reengineering initiatives, we also expect to continue to realize savings, which we reinvest to other key areas, through the following other reengineering initiatives:

- Savings from Increased Individual Master File (IMF) E-Filing (Reduction: –\$7,700,000 and –190 FTE; Reinvestment: +\$7,600,000 and +12 FTE).*—This savings is based on processing efficiencies from the projected decrease in IMF paper returns and processing costs for electronically filed IMF returns in Submission Processing Centers. These savings will be reinvested to enable us to continue our consolidation of IMF returns processing into fewer Submissions Processing sites.
- Consolidation of Case Processing Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: –\$66,654,000 and –649 FTE; Reinvestment: +\$66,654,000 and +585 FTE).*—Staffing for conducting case processing activities that support our examination, collection and lien-processing programs will be consolidated from nearly 100 sites and centralized among four campuses (Philadelphia, Cincinnati, Ogden and Memphis).
- Consolidation of Insolvency Activities to Maximize Resources Devoted to Front-Line Operations (Reduction: –\$14,928,000 and –134 FTE; Reinvestment: +\$14,928,000 and +156 FTE).*—Staff conducting insolvency operations to protect the government's interest in bankruptcy proceedings will be consolidated from numerous sites and centralized at the Philadelphia campus.
- Detection and Deterrence of Corrosive Corporate Non-Compliance (Reduction: –\$6,711,000 and –52 FTE; Reinvestment: +\$6,711,000 and +52 FTE).*—By using improved issue-management and risk-assessment strategies for examining corporations, the IRS expects to realize productivity improvements. These savings will be reinvested to fund front-line enforcement activities.

Finally, the fiscal year 2006 request includes several program increases, totaling \$264.6 million:

- Attack Corrosive Non-Compliance Activity Driving the Tax Gap (+\$149,700,000 and +920 FTE).*—This initiative increases coverage of the growing number of high-risk compliance problems and addresses the largest portion of the tax gap—underreporting of tax. It proposes a funding increase across all major domestic and international compliance programs to leverage new workload-selection systems and case-building approaches from continuing reengineering efforts.
- Detect and Deter Corrosive Corporate Non-Compliance (+\$51,800,000 and +236 FTE).*—This initiative addresses complex, high-risk issues in abusive tax avoid-

ance transactions, promoter activities, corporate fraud, and aggressive domestic and off-shore transactions, resulting in increased corporate and high-income return closures and audit coverage. This initiative also includes critical post-filing support provided by outside experts to expedite the resolution of issues at the field examination level, reducing taxpayer burden, and increasing the credibility of the Service's positions on the most complex and potentially highest compliance impact issues sent to court.

—*Increase Individual Taxpayer Compliance (+\$37,900,000 and +417 FTE).*—This initiative addresses the tax gap through: the identification and implementation of actions needed to address non-compliance with filing requirements; increased Automated Underreporter resources to address the reporting compliance tax gap; increased audit coverage; and expanded collection work in Taxpayer Assistance Centers.

—*Combat Abusive Transactions by Entities with Special Tax Status (+\$14,460,000 and +77 FTE).*—This initiative focuses on the most egregious cases of non-compliance and identifies compliance risks sooner, reducing burden on compliant customers and enabling the development of new interventions to curtail the growth of abusive transactions.

—*Curtailling Fraudulent Refund Crimes (+\$10,772,000 and +22 FTE).*—This initiative is aimed at attacking the increased questionable refunds and return preparer fraud identified through expanded operations of the Fraud Detection Centers located on IRS campuses. Fraudulent refund schemes are one of the most serious threats to voluntary compliance and an IRS investigative priority.

The fiscal year 2006 request of \$10.7 billion funds the IRS's three appropriations: Tax Administration and Operations (TAO) for operations, service and enforcement; Business Systems Modernization (BSM) for modernization; and, the Health Insurance Tax Credit (HITCA) for administering a refundable tax credit for qualified individuals. I will describe each in turn.

TAX ADMINISTRATION AND OPERATIONS (TAO)

For fiscal year 2006, we request funding of \$10,460,051,000, an increase of 4.6 percent over the fiscal year 2005 appropriation of \$9,998,164,640 for programs previously funded from the PAM, TLE, and ISY appropriations.

The TAO appropriation provides resources for the IRS's service and enforcement programs. The IRS is responsible for ensuring that each taxpayer receives prompt and professional service. To that end, the IRS's assistance, outreach, and processing activities funded in the TAO appropriation are dedicated to providing assistance to taxpayers in all forms—electronic interaction, published guidance, paper correspondence, telephone contact, and face-to-face communication—so that taxpayers may fulfill their tax obligations timely and accurately. It also includes the resources the IRS requires to handle the processing and disposition of tax returns, refunds, and other filing materials.

We are also responsible for the fair enforcement of the Nation's tax laws. Each year, a small percentage of taxpayers file erroneous returns or, for reasons both innocent and less benign, fail to file a return at all. The IRS conducts enforcement activities using a variety of methods, including correspondence audits, matching reporting documents (such as Forms W-2) to information on taxpayer returns, in-person audits, criminal investigations of those suspected of violating tax laws, and participation in joint governmental task forces. The IRS's examination, collection, investigations, regulatory compliance, and research activities funded in the TAO appropriation provide the resources required for equitable enforcement of the tax code and the investigation and prosecution of individuals and organizations that circumvent tax laws.

BUSINESS SYSTEMS MODERNIZATION (BSM)

The IRS tax administration system, which collects \$2 trillion in revenues annually, is critically dependent on a collection of 40-year-old, obsolete computer systems. Recognizing the long-term commitment needed to solve the problem of modernizing these antiquated systems, Congress and the administration created a special business systems modernization account. They designed the BSM program to bring the IRS's business systems to a level equivalent with best practices in the private and public sectors while managing the risks inherent in a program that is unquestionably one of the largest, most visible, and most sensitive modernization programs ever undertaken.

In 2004, the modernization budget was \$387 million. Based on the challenges the modernization program was facing, we realized the program needed to be smaller in 2005 so we requested a lesser budget of \$285 million. In the end, Congress appro-

appropriated \$203 million. One of the ways we are accommodating these changes is by substantially lowering the costs of the core infrastructure as well as the architecture, integration, and management parts of the BSM program in 2005. These two areas are the programmatic elements of the program, and cost \$160 million in fiscal year 2004. We certainly cannot justify that level of continued investment for a program that is roughly \$200 million. Therefore, we are dramatically reducing those core services to \$107 million in fiscal year 2005 and we anticipate making additional reduction in fiscal year 2006. For fiscal year 2006, we request funding of \$199 million for all BSM activities, substantially the same funding as the fiscal year 2005 appropriated level.

Our most successful year ever for the modernization program was 2004; we measured our success by the number of projects we delivered, the schedule and cost targets we hit, and the substantial improvements we made in program management.

We delivered the first release of the Customer Account Data Engine (CADE) project in July 2004, allowing the IRS to process an initial set of the simplest tax returns on a new computer system for the first time in 40 years. We launched IRS's new Integrated Financial System (IFS), and declared it the IRS's financial accounting system of record. IFS will provide the capability for improved timeliness and accuracy of the financial reports and information available to IRS management and key stakeholders, facilitating continued clean financial audit opinions of the IRS. We deployed a full suite of e-Services products, providing tax professionals and businesses with new Web-based tools that dramatically improve their interface with the IRS. Additionally, we released Modernized e-File, whereby corporations and tax-exempt organizations can file their annual income tax and information returns electronically.

We have also made significant improvements in our cost estimating and scheduling. In the Fall and Winter of 2003, we re-baselined the cost estimates and delivery schedules for each of the BSM program projects. Since then, we have shown a marked improvement in significantly reducing our variances between cost estimates and actual delivery costs from 33 percent in 2002 to 4 percent in 2004.

In terms of improving program management, we identified four key areas that we had to address to enhance the performance of the modernization program:

- Resizing our modernization efforts to better align with our management and skill capacity;
- Engaging IRS business units to drive the modernization projects with a business focus;
- Improving contractor performance on cost, schedule, and functionality; and
- Hiring outside executives to achieve a better balance between large project management and tax administration experience.

We have made significant progress in addressing each of these major challenges. First, the IRS will concentrate on a few key projects and will develop a track record of improved management and successful delivery of modernization projects.

Second, the IRS assigned a business unit leader to each project with responsibility for leading the related BSM Governance Committee, and sharing accountability for delivering the modernization project as stated in their annual performance commitments.

Third, we are making real progress in improving the accountability of the PRIME contractor. I meet monthly with the Chief Operating Officer of the Computer Sciences Corporation (CSC) to reinforce the accountability of the contractor to the IRS. Additionally, we have made major progress in restructuring BSM project contracts with the PRIME that shift an appropriate amount of financial risk to the contractor and tie costs to performance. These steps have resulted in improved contractor performance, as demonstrated in the deliverables in 2004 and the general adherence to costs and schedules.

Fourth, we have made great progress in hiring experienced executives and seasoned managers from outside the agency who have expertise in running large-scale information technology programs and projects. A little over a year ago the mix of leadership at the top of the BSM program consisted of one outside expert and six internal IRS executives. Today, that mix will soon be five outside experienced outside experts and three internal IRS executives. This mix is a much better balance of the project management and technology talent and tax administration experience needed to successfully run the BSM program.

While we were very successful in 2004, we have a lot of work ahead of us. It is critical that we continue this level of performance in 2005 and beyond.

Our focus for fiscal year 2005 is on maintaining substantial modernization work for three key tax administration systems that will provide additional benefits to taxpayers and IRS employees, specifically:

- The Customer Account Data Engine (CADE) project;

- Modernized e-File; and
- Filing and Payment Compliance (F&PC).

CADE

CADE replaces the IRS's antiquated system called the Master File which is the Service's repository of taxpayer information. With CADE being the core fundamental component of the modernized systems, it is the IRS's highest priority technology project.

We cannot over-emphasize the importance of CADE. The current Master Files have served the IRS for more than 40 years. However, they were developed in a different era and rely on an obsolete programming language and a flat-file system that still requires batch updates. These systems are very expensive to maintain; development of new applications costs the IRS two to three times what it would cost if they were already retired. Yet the IRS must update the Master Files every year to take into account tax law changes. As importantly, the vast majority of the workforce who are familiar with these old systems will be retiring over the next few years and we cannot hire individuals with these obsolete skills. Until the Master Files are replaced, the IRS can not offer service approaching what a typical financial services firm offers today (such as full account views for employees and real-time account updates and settlement).

The returns we are processing in CADE are the most basic of 1040EZ forms and have a narrow range of taxpayer information, but it marks the first time since the 1960's that the IRS has processed individual tax returns in a new way. The success of CADE proves that we can deliver technology that will process tax returns on a 24-hour cycle, breaking the 40-year-old standard of processing on a weekly cycle. As of March 25, 2005, CADE had processed 965,000 returns and generated nearly \$318 million in refunds to taxpayers. This achievement is significant. CADE will have processed over 1 million 1040EZ tax returns by the time of this hearing and for the 2005 filing season that figure should reach over 1.3 million returns.

The CADE system is scheduled to be phased in over several years, processing increasingly more complex tax returns. When fully operational, CADE will be a modern database that will house tax information for more than 200 million individual and business tax returns. It will provide a variety of benefits to taxpayers, such as faster refunds (by over 50 percent) along with daily postings of transactions and updating accounts, which (with other technology elements) will significantly improve customer service and enforcement. With CADE, we will have the flexibility necessary to respond quickly to our complex tax law and tax reform changes.

One of the most significant changes that we introduced in 2004 was the segmentation of CADE releases into two annual deliveries—one in July and one in January. The July delivery will involve higher risk, more complex functionality, and the January delivery will include filing season changes combined with additional changes as capacity permits. For the July release, returns will be available from the previous 6 months which will enable us to test the higher risk, complex changes with high volumes, and then go live with reduced volumes, which will mitigate the operational risks.

MODERNIZED E-FILE

Modernized e-File will provide a single point Federal/State filing option for Forms 1120, 1120S (corporations) and 990 (tax-exempt organizations) returns in many States via a Web Services interface. Our work on Modernized e-File will be comprised of Release 3.1, which includes additional Forms 1120, 7004 (Application for Automatic Extension of Time to file Corporation Income Tax Return) and 990, and tax law changes for filing season 2004. Release 3.1 deployed initial operating capabilities on schedule on January 10, 2005. Release 3.2 will provide an interface with State tax information retrieval systems and a redesign of the signature matching process for Form 8453 (U.S. Individual Tax Declaration for Electronic Filing).

FILING AND PAYMENT COMPLIANCE/PRIVATE COLLECTION AGENCIES

In 2004, Congress passed the American Jobs Creation Act, allowing the IRS to use Private Collection Agencies (PCAs). The legislation authorized the IRS to augment our collection efforts by allowing us to use PCAs to pursue what has been deemed as uncollectible tax liabilities; these agencies will not have enforcement authority and will only contact delinquent taxpayers to arrange voluntary, full-payment installment agreements. We will use the Filing and Payment Compliance (F&PC) system to analyze tax collection cases and divide the complex cases requiring direct IRS involvement from the simple "balance due" cases that can be handled by PCAs. The use of PCAs is to supplement—not supplant—current IRS personnel.

Quite frankly, this activity is geared for an inventory that the IRS currently can not chase with existing resources.

PCAs will benefit the IRS in three major ways:

- PCAs will help reduce the significant and growing amount of tax liabilities deemed uncollectible.
- PCAs will help maintain taxpayer confidence in our tax system.
- PCAs will allow the IRS to focus on more difficult cases and issues.

We expect to issue a Request for Procurement (RFP) in the next several weeks. We plan to award contract in June 2005, to begin an initial limited release of the uncollected tax inventory in January 2006. We provided all interested parties notification via the IRS.gov/Business Opportunity webpage and electronic letters.

Safeguarding taxpayer rights is paramount. The same IRS standards for customer service and protection of taxpayer rights will be strictly enforced. PCAs will be prohibited from threatening or intimidating taxpayers or implying that enforcement action will be taken against them. Specific safeguards to protect the taxpayer include:

- Fair Debt Collection Practices Act protections;
- Protections against unauthorized disclosures;
- Assistance from the National Taxpayer Advocate; and,
- Protections with respect to third party contacts, installment agreements and communications.

The IRS expects to place cases with PCAs using the following criteria:

- The taxpayer does not dispute the liability;
- The liability is reportable on the Form 1040 series of returns;
- The balance due is greater than \$100; and,
- The case does not involve a restriction on collection or otherwise indicate that discretion or enforcement action may be required to resolve the liability.

The delivery of the CADE project was a major milestone, but we still have a long way to go and a lot of work ahead of us as we introduce technology changes and expand into processing more complex tax returns at greater volumes. To that end, we recognize that a project of this complexity must continually look at new technologies that can support the level of development and implementation productivity needed for a project of this scale.

We certainly hope, and expect, that we will build on the successes of 2004, and we will continue to mature the modernization program by gaining a solid reputation for on-time deliveries with high productivity.

HEALTH INSURANCE TAX CREDIT ADMINISTRATION (HITCA)

In August 2002, the President signed Public Law 107-210, the Trade Act of 2002, which, among other things, provides a refundable tax credit for the cost of health insurance for certain individuals who receive a trade readjustment allowance or a benefit from the Pension Benefit Guaranty Corporation (PBGC). The Health Insurance Tax Credit Administration (HITCA) Appropriation funds the costs to administer a refundable tax credit for health insurance to qualified individuals. The tax credit is equal to 65 percent of the health insurance premium paid by eligible persons for themselves and qualifying family members. For fiscal year 2006 we request funding of \$20,210,000, a decrease of 41.5 percent below the fiscal year 2005 appropriation of \$34,562,272. Costs for the HITCA program have declined since implementation due to our active program oversight and management, as well as several cost-cutting initiatives we began to implement in March 2004. We developed a comprehensive action plan outlining cost-reduction initiatives and are following it to achieve these significant savings.

PROGRAM PERFORMANCE

The IRS expects to achieve the following levels of performance after attaining full performance of the requested fiscal year 2006 initiatives:

- Increase in field examinations for high-income individuals with complex returns; significant increase in collection processed; and closing of over 40 percent more delinquent balance-due accounts in fiscal year 2008 than in fiscal year 2004.
- Nearly double the audit coverage for individuals with income between \$250,000 and \$1 million, from 1.5 percent in fiscal year 2004 to 2.8 percent in fiscal year 2008.
- Auditing 15 percent more individuals earning above \$1 million, from 3.4 percent projected for fiscal year 2004 to 3.9 percent in fiscal year 2008.
- Significantly more collection cases processed, closing 50 percent more delinquent accounts in fiscal year 2008 than fiscal year 2004.

- Double the audit coverage for mid-size corporations, from 7.6 percent in fiscal year 2004 to 16 percent in fiscal year 2008.
- Increased efforts to deter abusive tax shelters among corporations.

LEGISLATIVE PROPOSALS

The President's fiscal year 2006 request includes several proposals that will assist me in managing the agency more efficiently and effectively. These proposals, if enacted, will allow us to focus more resources on high-income, high-risk areas, automate several routine transactions, use electronic data to reduce costly manual transactions, consolidate resources related to judicial and counsel review, and broaden administrative authorities and accesses to support further electronic administration and tax reform. We are seeking to:

- Make Section 1203 of the IRS Restructuring and Reform Act of 1998 more effective and fair;
- Curb the use of frivolous submissions and filings made to impede or delay tax administration;
- Allow for the termination of installment agreements for failure to file returns and for failure to make tax deposits;
- Consolidate judicial review of collection due process cases in the United States Tax Court;
- Eliminate the monetary threshold for counsel review of offers in compromise;
- Allow the Financial Management Service to retain transaction fees otherwise paid from IRS appropriations from levied amounts to recover delinquent taxes;
- Extend the due date for electronically filed returns to provide additional incentive for taxpayers to e-file and expand the authority to require electronic filing by businesses and exempt organizations; and,
- Allow IRS to access information in the National Directory of New Hires for tax administration purposes.

CONCLUSION

The IRS has lagged behind, for reasons that are understandable, in tax enforcement. But that is changing. We will continue to improve service and respect taxpayer rights. But we will also enforce the law. We won't relax until taxpayers who are unwilling to pay their fair share see that that is not a worthwhile course to follow.

Mr. Chairman, the great majority of Americans honestly and accurately pay their taxes. Average Americans deserve to feel confident that, when they pay their taxes, their neighbors and competitors are doing the same.

The President's budget request will help us enforce the tax law more fairly and efficiently. I am most grateful for your support of increased enforcement, and I look forward to working with you on this important budget request.

Thank you very much. I am happy to take your questions.

Senator BOND. Thank you very much, Commissioner. Now we turn to Mr. George.

Now, again, as I said, your full statement will be submitted as a part of the record and we invite you to give a summary.

STATEMENT OF J. RUSSELL GEORGE

Mr. GEORGE. Thank you, Mr. Chairman. Chairman Bond, Ranking Member Murray, Senator Dorgan. Thank you for the opportunity to testify this morning. As you consider the fiscal year 2006 appropriation for the Internal Revenue Service, while I've held the position of Treasury Inspector General for Tax Administration for a little over 3 months, many of the issues I will discuss today are issues that I worked on over a decade ago. I served as a staff director and chief counsel of the House subcommittee with oversight responsibilities of the management and financial accounting practices of Federal agencies including the Internal Revenue Service. Unfortunately, many of the very same challenges facing the IRS not only persist 10 years later but in some cases have actually worsened. The office of the Treasury Inspector General for Tax Administra-

tion or, TIGTA, has identified 10 significant challenges facing the Internal Revenue Service.

They are: modernizing IRS systems, ensuring tax law compliance, reducing tax law complexity, preventing erroneous and improper payments, providing quality customer service, protecting taxpayers and taxpayer rights, securing IRS employees, facilities, and information systems, integrating performance and financial management, managing human capital, and finally processing returns and implementing tax law changes during the tax filing season.

My written statement addresses each of these challenges. Given the time constraints I will limit my comments to three of these issues, those being modernizing IRS systems, providing quality customer service, and ensuring tax law compliance.

The first issue, modernizing IRS computer systems, that's been a persistent challenge for many years. Unfortunately, it will likely remain a challenge for the foreseeable future. In 1986 the IRS initiated the tax systems modernization program to replace its antiquated computer systems. After spending over 10 years and approximately \$3 billion on tax systems modernization the program was scrapped and a new effort was begun. The new effort is called Business Systems Modernization. It is estimated that this modernization effort will last up to 15 years and cost over \$8 billion. While the program is progressing the modernization effort is behind schedule, it is over budget and it's still delivering less functionality than originally planned. TIGTA, the government accountability office, and the IRS oversight board have all expressed concerns about the ability of the IRS to effectively manage its portfolio or modernization projects. To succeed the IRS must demonstrate that it can handle the overall management of the modernization effort.

A second challenge facing the IRS is one that affects many taxpayers this time of year, receiving quality customer service. As the commissioner noted in his testimony the IRS has made progress in customer service, however, I am concerned that the IRS may take a step backwards on customer service if it follows through with the proposal to close many taxpayer assistance centers. The taxpayer assistance centers are walk-in sites where taxpayers can receive answers to both account questions and tax law questions as well as receive assistance preparing their tax returns. The IRS is considering closing nearly 20 percent of the approximately 400 taxpayer assistance centers nationwide. As part of an ongoing audit we at TIGTA are reviewing the methodology used by the IRS to determine which taxpayer assistance centers to close. At this point I am skeptical that the IRS has adequate data to assess the impact that closing these centers will have on customer service. I'm also concerned that the IRS has insufficient data to draw conclusions on the likelihood that taxpayers who used these centers in the past will be able to use other methods of seeking help, such as the Internet or telephone. I strongly recommend that the IRS further research these issues before closing selected taxpayer assisted centers.

Finally, on the topic of improving tax law compliance the IRS continues to and will always face challenges in ensuring that taxes

are paid of time. According to IRS estimates the tax gap, which again is defined as the difference between what taxpayers are supposed to pay and what is actually paid is as noted approximately between \$312 and \$353 billion each year. To improve tax compliance the IRS must begin to use private contractors to collect taxes in the next year. While the use of private collection agencies could result in significant recoveries of unpaid taxes the potential for abuse exists. My office has developed a three-phase strategy to monitor this initiative. We will be vigilant in ensuring the IRS effectively uses its new authority to use private debt collectors while also ensuring that taxpayers due rights and privacy rights are protected.

PREPARED STATEMENT

Mr. Chairman, members of the subcommittee, I hope this brief discussion of three of the major challenges facing the IRS aids you as you consider its fiscal year 2006 appropriation. Thank you for allowing me to share my views. I look forward to taking whatever questions you might have at the appropriate time.

[The statement follows:]

PREPARED STATEMENT OF J. RUSSELL GEORGE

INTRODUCTION

Chairman Bond, Ranking Member Murray, and members of the subcommittee, I thank you for the opportunity to testify as you consider the fiscal year 2006 appropriations for the Internal Revenue Service. As the relatively new Treasury Inspector General for Tax Administration—having been on the job for 16 weeks—my observations are based on the body of work my organization has developed through audits and investigations of the IRS. I will focus on the major challenges facing the IRS to assist you in your consideration of the IRS's fiscal year 2006 budget.

Though I have been the Treasury Inspector General for Tax Administration (TIGTA) for only a few short months, my first experience conducting oversight of the Internal Revenue Service (IRS) dates back a number of years. In 1995, one of the initial charges I received as staff director of the House Subcommittee on Government Management, Information and Technology was to examine inefficiency at the IRS. Under then Chairman Stephen Horn's leadership, we reviewed several issues such as the IRS's tax systems modernization program, as well as ways to improve Federal debt collection practices. A decade later, I am disappointed to report that some of the same concerns Chairman Horn reviewed 10 years ago continue at the IRS today.

While the IRS faces longstanding challenges, it deserves credit for making marked progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Commissioner Everson's guiding principle for the IRS is Service + Enforcement = Compliance. Over the past few years, TIGTA audits have shown the accuracy of information provided by the IRS to taxpayers with tax law questions has generally improved, the average time spent by taxpayers waiting for IRS assistance on the phone or in person has declined, and the general professionalism with which taxpayers were treated by the IRS has increased. Since most interactions between the IRS and taxpayers involve these types of customer services, it is encouraging to see that the IRS's focus on customer service has made headway.

CHALLENGES FACING THE IRS

Despite such progress in customer service, improvements need to be made in this and other areas where significant challenges face the IRS in accomplishing its mission. The Treasury Inspector General for Tax Administration (TIGTA) has identified the following management and performance challenges that confront the IRS:

- Modernizing IRS Systems;
- Ensuring Tax Law Compliance;
- Reducing Tax Law Complexity;
- Preventing Erroneous and Improper Payments;

- Providing Quality Customer Service;
- Protecting Taxpayers and Taxpayer Rights;
- Securing IRS Employees, Facilities, and Information Systems;
- Integrating Performance and Financial Management;
- Managing Human Capital; and,
- Processing Returns and Implementing Tax Law Changes during the Tax Filing Season.¹

Each of these areas presents its own unique challenges, which will be addressed individually in the remaining portion of my testimony.

MODERNIZING IRS SYSTEMS

Modernizing the IRS's computer systems has been a persistent challenge for many years, and will likely remain a challenge for the foreseeable future. As I noted above, back in 1995, under Chairman Stephen Horn's leadership, the House Subcommittee on Government Management, Information and Technology began reviewing what was then referred to as tax systems modernization.

The IRS initiated the tax systems modernization program in 1986. The purpose of the tax systems modernization program was to replace the antiquated computer systems that the IRS still relies on today to conduct tax administration. The tax systems modernization program intended to create a tax processing environment that was virtually paper-free, an environment where taxpayer information would be readily available to IRS employees to update taxpayer accounts and respond to taxpayer questions.² The program, however, was plagued by management and technical weaknesses.³ After spending over \$3 billion on tax systems modernization,⁴ the program was scrapped and a new effort was begun under a fresh moniker, Business Systems Modernization (BSM) program.

This latest effort to modernize the IRS's systems, the BSM program, began in fiscal year 1999. The purpose of the BSM program is to modernize the IRS's technology and related business processes. According to the IRS, this effort will involve integrating thousands of hardware and software components. Through March 2005, the IRS has received appropriations of approximately \$1.8 billion to support the BSM program, and the fiscal year 2006 budget requests an additional \$199 million. It is estimated that the BSM program will last up to 15 years and cost over \$8 billion.⁵

Succeeding in the modernization effort is critical—not only because of the amount of time and money at stake—but also to improve the level of service provided to taxpayers. To accomplish the modernization effort, the IRS hired the Computer Sciences Corporation (CSC) as the PRIME⁶ to design, develop, and integrate the modernized computer systems.

The joint effort between the IRS and CSC has shown progress. In July 2004, the IRS released the first part of the Customer Account Data Engine (CADE) project. The CADE is the foundation for managing taxpayer accounts in the modernization plan. The CADE will replace the IRS's existing Master File.⁷ Once fully operational, the capabilities of the CADE will far surpass those of the Master File.⁸

The first release of the CADE allowed the IRS to process some of the simplest tax returns, Form 1040EZ, using a new database of taxpayer accounts. The IRS has also deployed projects that provide value to taxpayers, such as "Where's My Re-

¹The filing season refers to the period from January through mid-April when most individual income tax returns are filed.

²See General Accounting Office Report GAO/AIMD/GGD-98-54, *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems* (Feb. 1998).

³See General Accounting Office Report GAO/T-GGD-97-79, *IRS Management: Improvement Needed in High-Risk Areas* (Apr. 14, 1997).

⁴See General Accounting Office Report T-GGD-97-52, *Modernization of Processes and Systems Necessary to Resolve Problems* (Mar. 4, 1997).

⁵The Internal Revenue Service Has Appropriate Processes to Accept Modernization Software From Developers (Reference Number 2005-20-028, February 2005).

⁶The PRIME stands for Prime Systems Integration Services Contractor.

⁷The Master File is the IRS database for storing taxpayer account information on individuals, businesses, employee retirement plans, and exempt organizations.

⁸The CADE will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer account and return data. In conjunction with other applications, the CADE will allow employees to post transactions and update taxpayer account and return data on-line from their desks. Updates will be immediately available to any IRS employee who accesses the data and will provide a complete, timely, and accurate account of the taxpayer's information. In contrast, the current Master File processing system can take up to 2 weeks to update taxpayer accounts, and IRS employees may need to access several computer systems to gather all relevant information related to a taxpayer's account.

fund?,” the web-based application that allows taxpayers to check the status of their refunds. In addition, the IRS and its contractors have built the infrastructure needed to support these projects and have developed an enterprise architecture to guide the Business Systems Modernization (BSM) program.

Although progress is being made, the modernization program is behind schedule, over budget, and is delivering less functionality than originally planned. TIGTA, GAO and the IRS Oversight Board have expressed concerns over the IRS’s ability to effectively manage its portfolio of BSM projects. Both TIGTA and GAO have recommended that the IRS slow the pace of the BSM program due to some of the risks that have surfaced. Specifically, the imbalance between the number and pace of the BSM projects and available management capabilities has added significant cost, schedule, and performance risks that have continued to escalate.

In addition, TIGTA has identified four primary challenges that the IRS must overcome for modernization to be successful: (1) The IRS must implement planned improvements in key management processes and commit necessary resources to succeed; (2) The IRS must manage the increasing complexity and risks of the modernization program; (3) The IRS must maintain continuity of strategic direction with experienced leadership; and, (4) The IRS must ensure that CSC’s performance and accountability are effectively managed.

Without these four challenges being addressed, modernization will not succeed.⁹ In addition, IRS is reassessing its relationship with the PRIME contractor. For the past 6 years, the PRIME contractor has performed the role of system integrator and program manager for the BSM effort. In the new operating model, the IRS assumes responsibility for overall program management. The IRS must demonstrate that it can effectively manage the BSM program before its chances for success improve.

ENSURING TAX LAW COMPLIANCE

The IRS continues to face challenges in ensuring that taxes owed are paid on time. The importance of this issue cannot be overstated. The Nation’s ability to provide for the general welfare and protect its citizens is based on the ability to raise revenue through taxes. Yet, the tax gap, which the IRS defines as the difference between what taxpayers are supposed to pay and what is actually paid, is at staggering levels.¹⁰ On March 29, 2005, the IRS released updated estimates of the tax gap. For tax year 2001, the IRS estimated the annual gross tax gap¹¹ to be between \$312 billion and \$353 billion.¹²

For some time, the IRS, the Congress, and other stakeholders have been concerned about the slow erosion of voluntary tax compliance. IRS tax compliance programs must ensure that noncompliant taxpayers who do not meet their tax obligations are identified and penalized. The undermining of voluntary compliance begins when honest taxpayers believe that others are not paying their fair share.¹³

To improve tax compliance, the IRS must fully exercise its authority under the law. The American Jobs Creation Act of 2004 enables the IRS to use private contractors to collect unpaid taxes. While the use of private collection agencies could result in significant recoveries of unpaid taxes, the potential for abuse exists. TIGTA has developed a three phase audit strategy to monitor this initiative. In the first phase, TIGTA will review the IRS’s planning and initial implementation of the program. In the second phase, TIGTA will review the initiative after full implementation, which may not occur until fiscal year 2007. In the third phase, TIGTA will review the effectiveness of the program. The goal of this audit strategy is to ensure

⁹Annual Assessment of the Business Systems Modernization Program (Reference Number 2004–20–107, dated June 2004).

¹⁰See written statement of Commissioner of Internal Revenue Mark Everson before the Committee on Finance United States Senate Hearing on “Bridging the Tax Gap,” (July 21, 2004).

¹¹The amount of tax that is imposed for a given tax year, but is not paid voluntarily and timely.

¹²It is worth noting that the recently released tax gap figures noted above did not update key segments of the tax gap that are at least 15 years old, such as nonfiled tax returns and underreported corporate income tax for large corporations.

¹³The IRS fiscal year 2006 budget requests a significant increase in enforcement funds. As the IRS attempts to increase enforcement, it is worth considering the results of a 2003 GAO report. GAO found that the IRS’s frontline enforcement employees understood—but feared—section 1203 of the Internal Revenue Service Restructuring and Reform Act of 1998. Section 1203 outlines conditions for firing IRS employees for committing any of 10 acts of misconduct. These enforcement employees also reported that, because of section 1203, their work takes longer and the likelihood of their taking an enforcement action, such as recommending a seizure has decreased. See General Accounting Office Report GAO–03–394, IRS and TIGTA Should Evaluate Their Processing of Employee Misconduct under Section 1203 (February 2003).

that the IRS effectively uses its new authority to use private debt collectors, while also ensuring that taxpayers' due process and privacy rights are protected.

Congress has provided other statutory tools to the IRS to increase tax compliance. The IRS has the legal authority to charge a monetary penalty, called the Failure to Pay (FTP) tax penalty, against taxpayers who fail to pay their taxes on time.¹⁴ The law also requires the IRS to charge interest on FTP tax penalties.¹⁵ A recent TIGTA report found that the IRS computer system would assess the FTP tax penalty on taxpayers' accounts, but would not officially charge these assessments to accounts. By not assessing these penalties periodically, the IRS has foregone the interest associated with them. If the IRS had assessed all penalty accruals at least quarterly, TIGTA estimates that for calendar year 2002 alone, over \$817 million in interest on accrued penalties would be due to the IRS.¹⁶ This is one example of how the IRS could better use the tools at its disposal.

In addition to more fully exercising authority provided by Congress, the IRS must obtain timely and reliable data on the tax gap to improve tax compliance. To collect such data, the IRS launched the National Research Program, a study of individual taxpayer reporting compliance for tax year 2001. The National Research Program is intended to produce timely and reliable data that will allow the IRS to better target its limited enforcement resources on taxpayers who are not complying with the tax law instead of law-abiding individuals.

While timely and reliable data will help the IRS quantify noncompliant segments of the population, different approaches are also needed to determine how to most effectively address noncompliance. The Taxpayer Advocate's 2004 Annual Report to Congress depicts some of the complexities involved in structuring an enforcement program to address the tax gap. The Taxpayer Advocate also describes the efforts the IRS still needs to make to analyze the effectiveness of various compliance techniques.¹⁷ Similarly, in two recent audit reports, TIGTA identified examination programs that the IRS implemented nationwide before obtaining results on their possible effectiveness or before implementing an effective strategy to measure the results of the program.¹⁸

Accurate measures of the effectiveness of actions taken to reduce the tax gap are critical to the IRS for strategic direction, budgeting, and staff allocation. The Department of the Treasury also needs such measures for the purpose of creating tax policy. Additionally, the Congress could use this information to develop legislation that improves the efficacy of the tax system.

In addition to gathering better compliance data, TIGTA, other oversight groups, and interested stakeholders have made a number of recommendations to close the tax gap. These recommendations include: reducing the complexity of the tax code; instituting withholding on non-employee compensation; improving compliance with estimated tax payments; using document matching to verify business income; addressing escalating levels of late filed returns; increasing resources in the IRS enforcement functions; and addressing delays in systems modernization. While reducing the complexity of the tax code lies outside the authority of the IRS, the remaining recommendations are within the IRS's discretion and should be acted upon to further tax compliance.

¹⁴ 26 U.S.C. § 6651 (2004).

¹⁵ 26 U.S.C. § 6601(e)(2)(A) (2004).

¹⁶ This report also found that the IRS's current practice results in inconsistent treatment of taxpayers. Some taxpayers in hardship situations, such as victims of natural disasters or military personnel serving in combat zones, have accounts that are administered by the IRS manually rather than by computer. IRS personnel periodically calculate and manually assess penalties on these accounts. Because the manually computer FTP penalties are periodically assessed, interest is charged to these taxpayer accounts but not charged to taxpayer accounts administered by computer. Procedures Regarding the Failure to Pay Tax Penalty Result in Inconsistent Treatment of Taxpayers and Hundreds of Millions of Dollars in Lost Revenue (Reference Number 2005-30-052, dated March 2005).

¹⁷ National Taxpayer Advocate 2004 Annual Report to Congress (Dec. 31, 2004).

¹⁸ In TIGTA's judgment, the IRS implemented the High-Income Taxpayer Strategy, designed to target individuals with the financial resources to use sophisticated methods of tax avoidance, without a method and specific baselines to measure the strategy's success. In addition, the IRS introduced the Limited Issue Focused Examination (LIFE) process to reduce the length of examinations of large and mid-sized businesses. While the LIFE process has merit, the IRS implemented it nationwide before obtaining results on its possible effectiveness. The High Income Taxpayer Strategy Was Effectively Implemented, Although Its Success Still Needs to Be Determined (Reference Number 2005-30-012, dated November 2004) and The Limited Issue Focused Examination Process Has Merit, but Its Use and Productivity Are Concerns (Reference Number 2005-30-029, dated February 2005).

REDUCING TAX LAW COMPLEXITY

The scope and complexity of the United States Tax Code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles before meeting their tax obligations. The IRS has consistently sought to ease the process for all taxpayers, but each tax season brings new challenges, and old problems sometimes resist solution.

According to the Taxpayer Advocate's 2004 Annual Report to Congress, the most serious problem facing taxpayers and the IRS is the complexity of the Internal Revenue Code.¹⁹ The Joint Committee on Taxation conducted a study in 2001 that demonstrates the vastness of the tax code. The study found that, in 2001, the tax code consisted of nearly 1.4 million words. There were 693 sections of the code applicable to individuals, 1,501 sections applicable to businesses, and 445 sections applicable to tax exempt organizations, employee plans, and governments.²⁰

The complexity of the code hampers the ability of the IRS to administer the Nation's tax system and confuses most taxpayers. The IRS has attempted to provide assistance to taxpayers with questions about the tax code through toll-free telephone lines, Taxpayer Assistance Centers (TACs), kiosks, and the IRS internet web site. TIGTA has performed numerous audits of the accuracy of IRS responses to taxpayer questions submitted via these methods and found that even some IRS employees cannot apply the tax code correctly.

Our most recent audit of the accuracy of responses provided to tax law questions received via the toll-free telephone lines during the 2004 Filing Season found that 62 percent of the answers given were correct.²¹ The IRS conducted its own tests and found an accuracy rate of 79 percent. Both of these figures were well below the IRS's accuracy goal of 85 percent for this service. Tax law complexity contributes to the IRS's challenges in reaching these accuracy goals, as well as to taxpayer frustration with attempting to decipher the tax code.

Besides adding to the burden on the taxpayer and the IRS, tax law complexity also may inadvertently contribute to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's length and complexity by devising intricate schemes to illegally shelter income from taxation. Administering such a complex tax code makes the job of pursuing these abusive tax avoidance schemes challenging and costly to the IRS. For example, in 2004, the hours revenue agents spent per return on examinations increased by 23 percent for individual tax returns and 19 percent for corporate tax returns compared to 2003 figures.²²

As part of its goal to improve service to taxpayers, the IRS includes simplifying the tax process as an objective in its new Strategic Plan. Simplification could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax laws, however, can be a lengthy process since the IRS only administers the tax code that is passed by the Congress. Thus, the IRS must work extensively with these stakeholders, as well as the Department of the Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

PREVENTING ERRONEOUS AND IMPROPER PAYMENTS

One of the goals of The President's Management Agenda is to reduce erroneous payments.²³ Further, the Improper Payments Information Act of 2002²⁴ greatly expanded the administration's efforts to identify and reduce erroneous and improper payments in government programs and activities. While the administration has pushed to prevent erroneous and improper payments, stewardship over public funds remains a major challenge for IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud and abuse by program participants or Federal employees. For the IRS, improper and

¹⁹ National Taxpayer Advocate 2004 Annual Report to Congress (Dec. 31, 2004).

²⁰ Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Staff of the Joint Committee on Taxation, JCS-3-01 (Apr. 2001).

²¹ Additional Effort Answering Tax Law Questions Would Improve Customer Service (Reference Number 2004-40-150, dated August 2004).

²² TIGTA analysis of IRS Data Book information.

²³ The President's Management Agenda, announced in the summer of 2001, is the President's aggressive strategy for improving the management of the Federal Government. It focuses on five areas of management weakness across the Government where improvements should be made.

²⁴ Public Law No. 107-300, 116 Stat. 2350.

erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Some tax credits, such as the Earned Income Tax Credit (EITC), provide opportunities for taxpayer abuse. The EITC is a refundable credit available to taxpayers who do not exceed a certain amount of income per year. The EITC was intended to provide significant benefits to the working poor, but some taxpayers have abused the credit, which has resulted in a significant loss of revenue to the Federal Government. An IRS compliance study of tax year 1999 returns estimated between \$8.5 billion and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed for tax year 1999 should not have been paid.²⁵ A TIGTA review of EITC claimed for tax year 2002 estimated that the IRS allowed over \$16 million in potentially erroneous credits because the claimed qualifying “child” was significantly older than the primary taxpayer.

In addition to erroneous payments of credits, contract expenditures represent a significant outlay of IRS funds and are also susceptible to mistakes or abuse. The IRS approved payment of nearly a billion dollars for the Business Systems Modernization contract. Initially, neither the IRS nor the contractor could provide proper supporting documentation for approximately \$9.5 million (approximately 54 percent of the \$17.6 million sampled) in direct charges.²⁶ The contractor subsequently provided additional documentation, and TIGTA was able to verify all but approximately \$52,200. Nevertheless, to assure that its billings are adequately justified and to facilitate timely independent reviews, the IRS should strengthen its invoice review process by routinely requesting and reviewing a sample of supporting documents.

PROVIDING QUALITY CUSTOMER SERVICE

Providing quality customer service to the taxpayer is not only a primary goal of the IRS, but it is also one of its major management challenges. The Commissioner has frequently stated that service combined with enforcement will result in compliance. Quality taxpayer service includes helping the taxpaying public understand their tax obligations while making it easier to participate in the tax system.

Since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98),²⁷ the IRS’s focus on customer service has led to many improvements. Taxpayer satisfaction rates with the IRS have increased since the Act’s passage, growing almost 2 percent in 2004 alone.²⁸ Every year, the IRS helps millions of taxpayers understand their tax obligations by answering questions on its toll-free telephone lines or in person at local offices, making information available on its Web site, and responding to correspondence.

The IRS internet site, www.irs.gov, is an excellent source for forms, publications, and other guidance. Taxpayers visited the site over 139 million times last year.²⁹ The site also received an award for being the Nation’s most reliable government internet site.³⁰ Electronic filing of tax returns continues to grow, and the ability to check the status of tax refunds online has been a successful IRS project that is helpful to taxpayers.³¹

As for the toll-free telephone system, access by taxpayers to the IRS via telephone has improved. Callers were able to connect with the IRS more easily and received better, quicker service. Surveys of callers during the 2004 filing season showed that the vast majority of taxpayers were satisfied with the services they received.³² While the IRS exceeded its goals in professionalism and timeliness, the accuracy of answers provided to taxpayers on tax law questions slipped in 1 year from 73 percent to 62 percent. TIGTA attributed this decrease to IRS employees not always using the required Probe and Response Guide to obtain sufficient information from taxpayers or the employees were not correctly interpreting the tax law.

The IRS has obviously made strides in customer service over the past 7 years. TIGTA is concerned, however, that the IRS may disrupt the balance between cus-

²⁵ IRS report, Compliance Estimates for Earned Income Tax Credit on 1999 Returns (dated February 2002).

²⁶ Improvements Are Needed in the Invoice Review Process for the Business Systems Modernization Contract (Reference Number 2004–10–117, dated June 2004).

²⁷ Public Law No. 105–206, 112 Stat. 683 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

²⁸ Special Report on IRS Fiscal 2006 Budget, IRS Oversight Board, March 15, 2005.

²⁹ IRS.gov Cited As Most Reliable Government Web Site, IR–2004–131, October 25, 2004.

³⁰ Id.

³¹ Free File Tops Last Year’s Total, IR–2005–36, March 23, 2005.

³² Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season (Reference Number 2004–30–144, dated August 2004).

customer service and enforcement by closing many of its Taxpayer Assistance Centers. The TACs are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance preparing their returns. Over the past few years, customer service at Taxpayer Assistance Centers has shown improvement.³³ Yet, the IRS is considering closing nearly a quarter of its approximately 400 TACs nationwide. TIGTA is skeptical that the IRS has adequate data to assess the impact that closing TACs will have on customer service.

From the information provided by the IRS to TIGTA, the IRS is using the following criteria to select TACs to close: location, labor cost, facility cost, workload, and demographics. The last criterion, demographics, falls short of capturing the information needed to make a well-informed decision. To compile information on the demographics of a particular TAC location, the IRS is collecting data, by zip code, on population size, income level, age, unemployment, and percent of population who e-file. TIGTA believes this information is insufficient to draw conclusions on the capability and likelihood that taxpayers who have used these centers in the past will be willing to use alternative methods of seeking help, such as the internet or telephone. I strongly recommend that the IRS further research these issues before closing TACs.

PROTECTING TAXPAYERS AND TAXPAYER RIGHTS

Congress realized the importance of protecting taxpayers and taxpayer rights when it passed RRA 98. This legislation required the IRS to devote significant attention and resources to protecting taxpayer rights. The RRA 98 and other legislation require TIGTA to review IRS compliance with taxpayer rights provisions. Our most recent audit results on some of these taxpayer rights provisions are:

- Notice of Levy.*—TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. However, revenue officers who issue levies manually still are not always properly notifying taxpayers of their appeal rights.³⁴
- Restrictions on the Use of Enforcement Statistics to Evaluate Employees.*—The IRS is complying with the law. A sample review of employee performance and related supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.³⁵
- Notice of Lien.*—The IRS did not completely comply with the law. For example, the IRS did not always timely mail lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and for maintaining certified mail listings.³⁶
- Seizures.*—The IRS did not always comply with legal provisions and internal procedures when conducting seizures. The TIGTA review did not identify any instances where taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.³⁷
- Illegal Tax Protestor Designations.*—The IRS is prohibited by law from designating taxpayers as “illegal tax protestors” but may refer to taxpayers as “non-filers.” TIGTA has reviewed the Master File for illegal tax protestor designations. We found that the IRS has not reintroduced such designations on the Master File, taxpayer accounts that were formerly coded as illegal tax protestor accounts have not been assigned similar designations, and current IRS publications do not refer to illegal tax protestors. However, a few illegal tax protestor references still exist in manuals, job aids, computer systems, and isolated case files.³⁸

³³ Customer Service at the Taxpayer Assistance Centers Is Improving but Is Still Not Meeting Expectations (Reference Number 2005–40–021, dated December 2004).

³⁴ Additional Efforts Are Needed to Ensure Taxpayer Rights Are Protected When Manual Levies Are Issued (Reference Number 2004–30–094, dated April 2004).

³⁵ Fiscal year 2004 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results (Reference Number 2004–40–066, dated March 2004).

³⁶ Fiscal year 2004 Statutory Review of Compliance With Lien Due Process Procedures (Reference Number 2004–30–086, dated April 2004).

³⁷ Legal and Internal Guidelines Were Not Always Followed When Conducting Seizures of Taxpayers’ Property (Reference Number 2004–30–149, dated August 2004).

³⁸ Fiscal year 2004 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations (Reference Number 2004–40–109, dated June 2004).

—*Denials of Requests for Information.*—The IRS improperly withheld information from requesters in 4.4 percent of the Freedom of Information Act³⁹ and Privacy Act of 1974⁴⁰ requests, and 14.6 percent of the 26 U.S.C. § 6103 requests reviewed.⁴¹

—*Collection Due Process.*—IRS Appeals Officers and Settlement Officers substantially complied with the requirements of the law when conducting collection due process hearings. However, the Settlement Officers did not always address all the issues raised by the taxpayers.⁴²

Neither TIGTA nor the IRS could evaluate the IRS's compliance with three RRA 98 provisions since IRS information systems do not track specific cases. These three provisions relate to: restrictions on directly contacting taxpayers instead of authorized representatives, taxpayer complaints, and separated or divorced joint filer requests.

SECURING IRS EMPLOYEES, FACILITIES, AND INFORMATION SYSTEMS

As the Nation's primary revenue collector and an integral part of the Nation's critical infrastructure, the IRS is a prime target for anti-government protestors, international terrorists, and other extremists. Millions of taxpayers entrust the IRS with sensitive financial and personal data, which are stored and processed by IRS computer systems. The risks that sensitive data or computer systems could be compromised and that computer operations could be disrupted have increased over the last few years due to the external threats noted above and the increased connectivity of computer systems. In addition, IRS systems and data are vulnerable to unhappy taxpayers and disgruntled employees, as well as natural disasters. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

For the past 4 years, TIGTA assessments have concluded that the security infrastructure and the applications that guard sensitive data are weak because of inadequate accountability and security awareness, as well as insufficient training for key security employees. The IRS has focused on technical solutions to this issue, but the primary causes are managerial and operational factors. For example, in 2004, TIGTA found that while security roles and responsibilities have been defined, we continue to identify significant security weaknesses throughout the IRS that can be attributed to employees not fulfilling their responsibilities.⁴³ This results in the IRS failing to establish an organizational culture that strongly emphasizes the security and privacy of taxpayer data. In addition, some disaster recovery plans require additional development, testing, or personnel training to ensure that the IRS can quickly recover in the event of a disaster.

TIGTA has also identified security weaknesses in a number of IRS systems. For example, the IRS envisions the Security Audit and Analysis System (SAAS) as the audit trail collection and reporting system for the IRS's modernized applications. To date, no modernization applications are employing the SAAS for this purpose. This failure to employ the SAAS for audit trail collection and reporting results in at least two weaknesses. First, the IRS could deploy modernization applications without proper audit trail controls in place. Second, the IRS may spend additional resources to employ an application-specific audit trail that is not consistent with the IRS's architecture and would, in essence, represent a double investment in audit trail controls. Furthermore, the SAAS was accepted by the IRS despite the fact that it did not meet performance requirements.⁴⁴

The IRS has taken several positive steps toward improving security in the IRS. In October 2003, the IRS combined key security activities into a single organization to promote better performance and consistent customer focus. Adequate security policies and procedures have been established and, in most cases, the IRS has the

³⁹ 5 U.S.C. § 552.

⁴⁰ 5 U.S.C. § 552a.

⁴¹ Improvements Are Needed to Ensure Compliance With the Freedom of Information Act (Reference Number 2004-40-064, dated March 2004).

⁴² Appeals Complied With the Provisions of the Law for the Collection Due Process (Reference Number 2004-40-067, dated March 2004).

⁴³ Computer Security Roles and Responsibilities and Training Should Remain Part of the Computer Security Material Weakness (Reference Number 2004-20-155, dated September 2004).

⁴⁴ For example, the SAAS users cannot query the audit trail information to generate reports. In addition, the functionality and software performance problems of the SAAS prevent the IRS business units from using it to identify questionable activities on modernized applications. See The Audit Trail System for Detecting Improper Activities on Modernized Systems Is Not Functioning, (Reference Number 2004-20-135, dated August 2004).

necessary hardware and software to provide adequate system security. While the IRS has become a leader in government under this management structure, it must emphasize the importance of security to its employees.

For the IRS to make the largest strides in improving computer security at a relatively low cost, managers and employees must be aware of the security risks inherent in their positions and consider security implications in their day-to-day activities. Thus, IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations in a manner that protects employees and allows restoration of business operations in a timely manner. In addition, aggressive network control, monitoring, and incident response capabilities are necessary to prevent incursions into IRS systems from external and internal sources.

INTEGRATING PERFORMANCE AND FINANCIAL MANAGEMENT

The President's Management Agenda aims to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress; however, integrating performance and financial management remains a major challenge.

The IRS has achieved mixed success in establishing long-term goals to integrate performance and financial management. During the fiscal year 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures. However, TIGTA believes the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the IRS released the first results from its National Research Program and they provide fresh data on taxpayer voluntary compliance levels—the first in more than a decade. Such data is essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however, needs to develop a more strategic approach to the entire tax administration system. Such an effort would better identify the characteristics of an effective and efficient tax administration system, help pinpoint desired outcomes, and create a road map for the next decade that would complement the IRS's strategic, budget, and annual performance plans.

The IRS's financial statements and related activities also continue to be of concern to IRS stakeholders. The GAO audits the IRS's financial statements annually. The audit determines whether the IRS: (1) prepared reliable financial statements; (2) maintained effective internal controls; and, (3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996 (FFMIA).⁴⁵

In audits of the IRS's financial statements, the GAO has concluded that the records were fairly presented in all material respects.⁴⁶ The GAO, however, identified some continuing serious deficiencies in the IRS's financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. However, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS's financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

MANAGING HUMAN CAPITAL

Like much of the Federal Government, managing the extensive human capital resources at the IRS remains a serious concern. Workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for years. The GAO, the Office of Management and Budget, and the Office of Personnel Management have all made the strategic management of human capital a top priority. Specifically for the IRS, recent reorganization and modernization efforts, such

⁴⁵ Public Law No. 104–208, 110 Stat. 3009.

⁴⁶ Financial Audit: IRS's fiscal years 2003 and 2002 Financial Statement (GAO–04–126, dated November 2003).

as the focus on e-filing, have made many jobs dealing with processing paper tax returns redundant.

The Large and Mid-Size Business Division reported in its fiscal year 2006 strategic assessment that it will continue to lose substantial experience in the Revenue Agent position through attrition. Similarly, in the Small Business/Self-Employed Division, the human capital crisis continues to intensify as employees in key occupations increasingly become eligible for retirement, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups (e.g., Revenue Agents, Revenue Officers, Tax Compliance Officers), coupled with concerns regarding grade and competency gaps, further emphasize the need to strategically manage human capital.

The Tax-Exempt/Government Entities Division is already understaffed to handle the current volume of customer calls. The Division's toll-free service is still maturing and acquiring new customers; however, without additional staffing or system enhancements, the level of service will deteriorate. This issue requires immediate attention because the Division relies on quality toll-free customer service to help ensure voluntary compliance among its customers, since it has very limited resources for more traditional compliance activities like examinations.

In contrast, the Wage and Investment Division has reported that it has made significant progress in the human capital area. Examples include increased employee use of electronic learning and training by demand, and improved technical assessments for identifying skill levels and training needs of employees. In addition, the Division effectively planned and realigned its workforce as the result of reduced workload demands and technological improvements. Even so, more work needs to be completed to attract and retain high-quality employees, to increase productivity and quality, and to provide equal employment opportunities for all.

The Criminal Investigation function has also moved forward in this area. The function is implementing a computer-based knowledge management program, which can immediately identify current subject matter experts. Skill transfer programs will be implemented to provide continuity of technical subject matter expertise, and continuing education programs will provide updated training on emerging issues, strategies, and operational priority subjects.

The President's fiscal year 2006 budget may offer some relief in staffing shortages; however, the overall training and acclimation process will take some time. The IRS must devote significant attention to managing human capital to overcome the challenges noted above.

PROCESSING RETURNS AND IMPLEMENTING TAX LAW CHANGES DURING THE TAX FILING SEASON

Each filing season tests the ability of the IRS to implement tax law changes made by the Congress during the year. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer system used in processing returns.

This year's filing season includes significant tax law changes created by the American Jobs Creation Act of 2004.⁴⁷ One significant tax law change for the 2005 filing season that many taxpayers are familiar with is the ability to deduct sales tax instead of State and local income tax. Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Generally, the Congress makes changes to the tax law each year, so some level of change is a normal part of the IRS environment. However, certain kinds of changes can significantly impact the IRS in terms of the quality and effectiveness of service and in how taxpayers perceive the IRS.

To date, we have seen no significant problems during the 2005 filing season. During the 2004 filing season, most of the 123.1 million individual income tax returns received through May 28, 2004 (including over 60 million received electronically, an increase of nearly 16 percent from 2003) were timely and accurately processed. TIGTA determined that the IRS correctly implemented the key tax law changes that affected 2003 returns. However, TIGTA has previously identified tax law changes that have not yet been effectively implemented and could result in loss of taxpayer entitlements and erroneous tax reductions. For example, TIGTA identified taxpayers

⁴⁷Public Law No. 108-357, 118 Stat. 1418 (2004).

that are continuing to receive erroneous deductions for student loan interest, taxpayers with potentially unclaimed Additional Child Tax Credits, and taxpayers that were allowed questionable “dual benefits” for the tuition and fees deduction and the education credit.⁴⁸ These tax law changes must be effectively implemented to fairly apply the law to all taxpayers.

I hope this discussion of the major challenges facing the IRS aids you in your consideration of the IRS’s appropriation for fiscal year 2006. Mr. Chairman and members of the committee, thank you for allowing me to share my views. I would be pleased to answer any questions you might have at this time.

Senator BOND. Thank you very much, Mr. George. We will try to go 5 minutes each for questioning so all of us have an opportunity to go. Now, we will go as long as we can stand up to it. So let me begin.

Mr. EVERSON. As long as you can stand up to it.

Senator BOND. I haven’t lost too many witnesses at the witness table but there have been one or two occasions. I doubt if this will be the case today, but looking at BSM and the customer account data engine, CADE, which is essential for the BSM, we are concerned that IRS has re-baselined the program and has a moving set of requirements which obscures oversight and allows success to be measured in terms of garbage in rather than revenue coming out.

But let me ask two questions to begin. BSM, the biggest challenge you have, is fast approaching \$2 billion, with CADE as a key feature. I would like to know, No. 1, how much will it cost to include all 120 million individual taxpayers? Moreover, since CADE currently only allows for the processing of the easiest returns of taxpayers using the EZ form, how many filers will be processed during the 2004 tax season by CADE?

BUSINESS SYSTEMS MODERNIZATION

Mr. EVERSON. Let me back up and talk about the whole program for a moment, if I may? I agree with your characterization. As I stated, the whole program has been too costly and delayed, and didn’t get us the functionality we needed. When I came in 2 years ago I immediately commissioned a set of reviews. The set of reviews were consistent, the four different reviews, and the conclusions that were reached were that No. 1, we were too ambitious. We had been encouraged by the oversight board and others to move very quickly. And we spent hundreds or millions of dollars; the funding stream on this was \$400 or \$500 million a year at one point. We felt we needed to resize the portfolio. We had inadequate business unit involvement, meaning customers, people that were going to use these things in the process. We changed that as well. We had uneven performance by the contractor. Now, it would be easy to blame everything on the contractor, but I don’t think that was appropriate. The final thing is we had very little in the way of outside experts coming in and helping us, in terms of our staff. We’ve addressed each of those issues and I think that we have, as I said, turned a corner. We’ve reset dates and we met those dates last year in both CADE and in the financial system that we put on line.

⁴⁸The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented (Reference Number 2005-40-016, dated Dec. 2004).

So we brought down the funding level from about \$400 million to this \$200 million and we straight-lined it in fiscal year 2006, even though I think we could have made a case to increase it further this year. We want to proceed carefully and what we're doing now, Mr. Chairman, is limiting our ongoing work to just three areas so that we can stay on it. We're going to continue to work on this master file, the processing that includes the EZ's, and right now I think we're going to get 1.3 million or 1.5 million out of the total filing season for 2004. I can't tell you because we're not looking at how quickly this will ramp up over the years, what the remainder of the CADE program will be. We will get that number to you as soon as we've done some additional work on it. The second piece we're working on right now, as I indicated, is the collections. There's several hundred billion dollars of monies that haven't come in to the government. We need to update our systems so that we can work better, including the pieces done by the private collection agencies. That is the thrust of our modernization effort.

And the last is electronic filing. We have mandated electronic filing for corporations. This change will speed up our audits. It cuts 1½ years out of the audit process, which now goes 5 years. It's way too long for us to detect what's going on in these corporations. We're working on those three areas, very limited, and I think we will meet our deadlines and our cost targets as we go forward because our record in the last year has been good.

Senator BOND. Thank you, Commissioner. I would like to turn to Mr. George. How can the BSM be successful, within what time frame and at what cost? What is the TIGTA assessment?

Mr. GEORGE. That's a very difficult question to answer, Mr. Chairman. When you look at CADE and then look at the fact that it's over \$130 billion, \$130 million over budget, and 30 months behind schedule already, and then of course when you look at the TSM, the Tax Systems Modernization effort that occurred 10 years ago, it really doesn't give one a lot of encouragement that something as massive as BSM will be any much more successful unless a complete understanding as to what went wrong with TSM is had. I don't question that the current commissioner is examining the problems and has examined the problems of tax system modernization, but it involves not only the major prime contractor, Computer Science Corp, but many subcontractors. And we are in the process, Senator, of conducting audits on some of those sub-contractors and we'll share that information with this committee once those ordered audits are complete.

Senator BOND. We appreciate your continuing to share this information with us. This hearing is just the beginning of our inquiries and we look forward to having that information.

Let me ask one quick question to the Commissioner. Since the IRS is only getting 11 of the 15 items promised with the next CADE delivery in July, can you tell me how much the government will be refunded for the four dropped items?

CUSTOMER ACCOUNT DATA ENGINE

Mr. EVERSON. I'm not sure to which items you are specifically referring. I will certainly take a look at that and provide the information for the record. We've had ongoing discussions and negotiations

with the contractors and reached some pretty tough deals over the last year, where we've changed the way we're dealing with them and the relationship is subject to renegotiation. I want you to know my commitment here. I meet monthly with the President and chief operating officer of CSC and I've done that for a year and a half now, and their performance has improved significantly. We are continuing to hold their feet to the fire to make sure we get everything, every nickel's worth that the government pays.

Senator BOND. Thank you very much, Mr. Commissioner. Senator Murray.

Senator MURRAY. Thank you, Mr. Everson. I appreciate your testimony and as I talked about in my opening statement the IRS is talking about significant cuts to taxpayer services in order to pay for enforcement. You're proposing closing taxpayer assistance centers, reducing telephone service, eliminating phone-routing sites, discontinuing TeleFile, and reducing communications with practitioners. Last year, you published a comprehensive reorganization plan but those reductions are nowhere to be found in that plan. Why are you now suddenly proposing cuts when they were never a part of your recent reorganization plan?

IRS STRATEGIC PLAN AND TAXPAYER SERVICE

Mr. EVERSON. Do you mean you're citing a strategic plan? I'm not sure what you mean by the reorganization plan.

Senator MURRAY. The strategic plan that was published last year.

Mr. EVERSON. We have set out a strategic plan and it has three objectives, which are to continue to maintain and improve taxpayer services, to significantly enhance enforcement, and to modernize the IRS. And I think that plan has guided all of our internal work and our budget discussions. Now, the IRS is not protected from overall fiscal realities so we have been asked to do our share and we are going to do our share to tighten our belt where we can. What we've done is gone through a very detailed process, and my two deputies are leading a lot of discussions to tighten up where we can. We're making a lot of increases in productivity and efficiency. You mentioned reducing phone services as an example. We've taken a look at the phones. Right now we provide 15 hours of access. We're going to bring that down to 12 hours. That is comparable to what Social Security and Blue Cross/Blue Shield do. Ninety-three percent of the calls that come in fall within those 12 hours. We believe that we can save money through less overtime pay, but not reduce services there.

TAXPAYER SERVICE CENTERS

Closing the tax centers, I understand that that will cause some disruption of services. It is relatively higher cost services and our decisions here are based upon just as GAO said, an increase in things like the VITA volunteer centers. There are 14,000 VITA sites around the country. There will necessarily be a shifting of work to these sites. We see other changes. For instance, the calls coming into our telephone system now are down 6 or 7 percent this year. That reflects movement activity over to the Internet, where contacts have doubled.

Senator MURRAY. But there are always people who don't have access to the Internet.

Mr. EVERSON. Absolutely, Senator. You look at tele-file as an example where in terms of individuals, that usage has been going down 10 or 15 percent a year. I've asked our people to come up with what were the tough choices, instead of bleeding away and cutting everything over a period of years by 5 percent or something. To take a look at what we do and then make the hard choices to not do 110 different things, to strip off some of those so that we can do well what we ought to do. There are some tough choices here. I agree with you.

Senator MURRAY. But your budget says you want to improve taxpayer service by, "make it easier for people to participate in the tax system", and when you close centers that puts undue hardship on a number of people who are already living in more remote locations to travel further. So that is at odds with your statement, but let me ask you, how do you plan to measure the adverse impacts of these proposals on taxpayers?

TAXPAYER SERVICE CHANGES

Mr. EVERSON. What we have done is gone through a process that looks at five different considerations. We ended up developing two models and we've taken input from a variety of people, including an advisory committee, an IRS advisory committee, and I—

Senator MURRAY. It's a little hard to read.

Mr. EVERSON. I think you have copies of this. It's my understanding, anyway. If you don't, I'll give you mine.

Application of Criteria for Closing TAC Sites

Option I	Option II
67 TACs closed in 27 states/DC	105 TACS closed in 38 states/DC
Greater weight on employee and facilities costs	Greater weight on workload, demographics and geography
Affects more large offices in urban areas	Affects more small, medium offices in rural areas

Selecting TAC's begins with agreeing to the criteria that make up the model—stakeholders helped to determine the components

Model Criteria and Components		
Sub-Model	Criterion	Sub-Model Components
1	Geographic	<ul style="list-style-type: none"> • Traffic volumes (Filing and Non-Filing Season) • Distance to next nearest TAC • Distance to nearest VITA center • Distance to nearest library, post office, or kiosk
2	Employee Cost	<ul style="list-style-type: none"> • Number of managers, secretaries, IARs, TRRs, CSRs, and others • Number of employees at the TAC • Number of full-time, seasonal, and part-time employees • Total direct labor hours • Total overhead hours • Average salary • Average benefits • Retirement eligibility
3	Facilities Cost	<ul style="list-style-type: none"> • Space usage • Furniture cost • Square footage cost • Total rent/leasing cost • Length of rent/leasing contract • MITS cost
4	Workload	<ul style="list-style-type: none"> • Tax Law, Forms and Pubs., Return Preparation, Accounts workloads • Modernization efforts applied • Abandoned TACs
5	Demographic	<ul style="list-style-type: none"> • Population size by zip code • Income level by zip code • Poverty level by zip code • Percentage older than 65 by zip code • Population of Household income <\$35,000 • Number of Returns filed by zip code • Number of EITC Returns filed by zip code • Percentage breakout by ECO demographic categories • Percent of E-file by zip code • Percent Unemployed by zip code • Average Education Level by zip code • Percent of Households with Computers

Approximately 13,000 data points in the model criteria

We've looked across our system. We have 408 of these taxpayer assistance centers and have compared them using some three dozen factors that we have loaded into the models we've run. There are over 13,000 different data points, is my understanding. We're looking at geography. As you say, how far is it to the next TAC? How far is it to the next volunteer center? We'd look at the cost. Obviously, a part of this is trying to drive down cost and hold the funding to a reasonable cost. It includes employee cost, it includes a facilities cost. We've looked at workload, obviously. Some TACs that are in more rural states have one or two people as opposed to in larger cities. And we've looked at demographics, changes in the country. We had a team of 12 people that's been doing this work for the last several months and we've ended up developing two models. This was after an initial conversation we had with the taxpayer advocate who has said, make sure you're looking at things that affect taxpayer access and that gets more to this question of workload. And initially a model that we had had something like 37 TACs being closed. They were all in big locations, big cities, and high cost operations, but what we've now done is refine this to two different models. One of them ends up with 67 TACs closed in 27 States across the country. And that gives a slightly greater weight to employee facilities costs. The other ends up with 105 closed and that gives more weight to issues like workload and demographics. And the difference is, in some States you obviously end up with a deeper impact like in Washington or North Dakota or any place in going to the second model. Our inclinations are to go to option No. 1. We've been reviewing these options with others and we haven't reached any final decisions. We're still refining this.

Senator MURRAY. Well, let me ask Mr. George, because in your formal testimony you expressed concern to us that the IRS may disrupt a balance between customer service and enforcement by

closing some of these centers. Then you question whether the IRS has sufficient data to conclude the taxpayers that use these centers would be willing and able to use alternative methods to gain tax preparation assistance from the IRS. So given all of these uncertainties you've just seen do you believe the cost savings closing these centers will yield is worth the sacrifice that will be endured by taxpayers?

Mr. GEORGE. Senator, we have no evidence that it will or won't just because the data is not there. But the one thing that I would note that is striking in terms of what is missing from the components of the criteria that the commissioner noted is the behavior of those who use the taxpayer assistance centers. As was noted we truly do not know what options they will or will not pursue of this and I do not believe that the Internal Revenue Service has considered that as a factor when it's considered.

Senator MURRAY. Are you concerned that it's not a fair way to evaluate the system?

Mr. GEORGE. I think it is not a complete way in which to do it.

Senator MURRAY. Can you tell me exactly what you think needs to be added to it?

Mr. GEORGE. I think a very comprehensive survey of the users of the taxpayer assistance centers using a methodology which is reasonable given the large numbers that are affected by this, something of that sort, Senator.

LEGISLATIVE LANGUAGE

Mr. EVERSON. If I could prolong this for just a second. I want the committee to understand what the stakes really are here. I mentioned in the opening statement the impact if we're constrained from taking this action. We've gone through a very deliberate, careful process to try to squeeze down into the President's service mark. If you tell us not to do this and you use the President's mark for service as the ceiling, you will be doing things like forcing us into further cuts on services for telephones, stopping basic transcription of information like K1 data which we use for high income audits. We will be reducing support to our VITA programs because we have already gone through a whole series of belt tightening exercises over recent years. So I do caution you. Obviously, we will do whatever is said here but unless you——

EFFECT OF SERVICE REDUCTIONS

Senator MURRAY. Are you telling us costs savings for option No. 1 or option No. 2?

Mr. EVERSON. They both cost about \$52 or \$54 million, I can't remember which is which, but they're comparable for the two options.

Senator MURRAY. For what time period?

Mr. EVERSON. That is what comes out next year.

Senator MURRAY. But we don't know whether that will mean reduced number of taxes paid because people don't get the correct assistance.

Mr. EVERSON. I think that if we were to attempt to quantify that, it would be an excruciatingly long and detailed process because I've not seen any research that ties that kind of service changes directly

to taxes paid give that answer. You would have to wait years to get that answer.

Senator MURRAY. That may well be but if people do their taxes accurately the first time around it does save us money in not having to go back and forth with them.

Mr. EVERSON. I agree with that. I agree with what the chairman said that if we simplify all this we would get a lot better answers. Now we're working in other areas, like the VITA sites, where TIGTA and others have said the quality of their return preparation isn't what it ought to be. We're trying to increase that service so those are the kinds of considerations we have getting at just what you're talking about.

Senator MURRAY. I'm out of time.

Senator BOND. Thank you very much, Senator Murray. Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much. I thank you and the ranking member. At one point, I was a chairman and then ranking member of the subcommittee that funded the IRS. I've always been very supportive of the IRS. I'm a former Tax Administrator but I'll tell you over the years you almost run out of patience on this. This year we're told modernization, a program for which we have literally shoveled money out of this Congress, is behind schedule, over budget, and probably will produce a product less valuable than anticipated. You know at some point this is not the type of science that requires sending a person to the moon. Modernizing the computer system of the Internal Revenue Service ought to be able to be done. It is really disappointing to hear these reports and we do it every year. It's not just on your watch. Behind schedule, over budget, less valuable than we expect.

With respect to the tax gap I just wanted to make a couple of comments and ask you, Mr. Commissioner, to respond. The tax gap continues to grow. I think we need to increase enforcement in order to respond to that but we can't increase enforcement at the cost of closing taxpayer assistance centers in my judgment. For 2 years I put money in your budget for the Inspector General to go have people anonymously visit taxpayer assistance centers every 2 months and tell us about the quality of the taxpayer assistance. One of the reasons I did that is because a large percent of the time the IRS employees themselves were giving inaccurate information and couldn't complete the tax returns properly. The results were still pretty miserable, frankly. The Inspector General now has reported about 44 anonymous visits to IRS Volunteer Income Tax Assistance centers and here's what they found. These are the centers that you would increase I think if you close some taxpayer assisted centers. From February to April last year Inspector General employees conducted 44 anonymous visits to VITA sites. Thirty-five tax returns were prepared. None of them were prepared correctly. Of the 35, if 28 of those returns had been filed the IRS would have incorrectly refunded \$26,000. If the remaining 7 returns had been filed, the taxpayers would have failed to receive \$4,500 in refunds. For 9 of the 44 visits, tax returns were not prepared at all because the VITA sites weren't open, had been relocated or too many people were in line. But the fact is that of the 35 people who actually got help, none of them got correct help. All of them, 100 percent, incor-

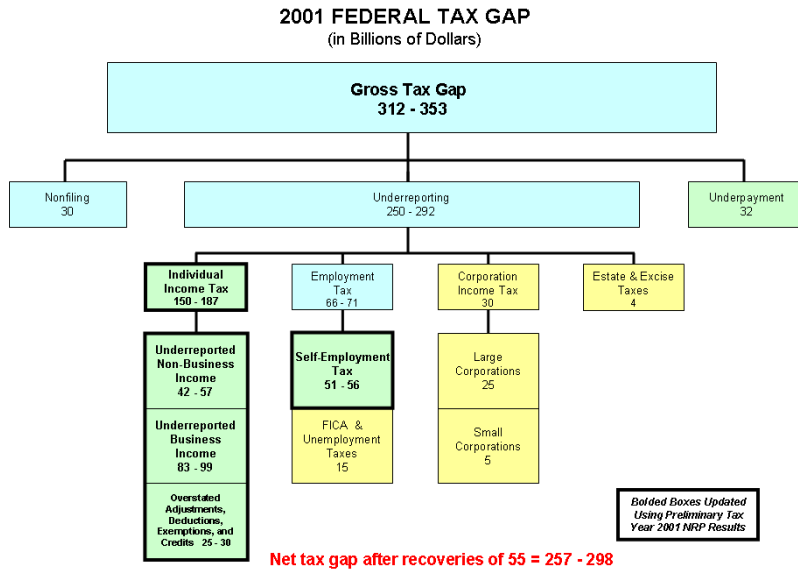
rect. And so I mean to close taxpayer assisted centers themselves—that themselves have a pretty miserable record. Relying on VITA sites, I think is the wrong thing.

Let me just say one other thing. I think big multinational corporations are having a field day with the Internal Revenue Service on the issue of transfer pricing. They're now doing business all across the world so you have related companies in this country and abroad. They are buying and selling to each other in order to move profits out of this country so that they can't be taxed. They inflate prices, or deflated prices as it were, and let me give you some examples. Tweezers, \$4,800 each purchased from your own subsidiary. That is an inflated price. Safety pins, \$29 each. Deflated prices, tractor tires for \$7. Pianos for \$50. Missile launchers for \$52. There are two professors, Doctors Simon Pak and John Zdanowicz at Penn State and Florida International University, respectively, who are doing some research, that I helped fund through an earmark to determine about how much tax revenue we may be losing due to abnormal pricing. The IRS is using the arms-length method to deal with their pricing abuses. It's like trying to take two plates of spaghetti and fuse the ends together. It is impossible and the corporations are having a field day. In my judgment, there's massive tax avoidance and nobody seems to do much about it. And there are some obvious answers to it. I don't have time to deal with it here but I wanted to make this final point.

We need more enforcement, better enforcement, smarter enforcement, and we need more taxpayer assistance and taxpayer assistance that is accurate. And if that requires additional funding we need to do that. You can't have a tax system you impose on the shoulders of the American people and say to them you comply even though paid IRS employees can't figure it out when a citizen walks up to get help. So you've got a tough job Mr. Everson. I want to be supportive of you but I'm telling you I'm really discouraged year after year to see modernization apparently failing and to see all of these other things pile up and the tax cap grow much larger. Now, is that a mouthful, and you deserve an opportunity to respond.

COMPLIANCE

Mr. EVERSON. You covered a lot of ground there. Maybe I'll be somewhat selective in what I respond to. Let's go to this chart.



No one has spoken more aggressively or acted more aggressively to go after corporations and high income individuals than I have since coming onto this job 2 years ago. We asked for more money last year. We didn't get it all, and the President's request again gives a great deal of focus, as you can see, to corporations. We're asking for \$63 million in new funding, and for high-income individuals compliance we're asking for \$46 million. I agree with your assessment. The corporations, it's a relatively small portion of the tax gap. We did not update the corporate tax gap in our work, but I suspect that the gap is understated. We are working aggressively on this. We're doing something like establishing a joint international tax shelter information center here in town with counterparts from Britain, Australia, and Canada. We're sharing information and we're seeing many of the things you're talking about. Corporations, in too many instances, are not just interested in going through a low tax jurisdiction, they want to set up transactions that have two different treatments in two different taxing jurisdictions, and then no taxes paid. So we're working on this very aggressively. We do need that funding to keep giving that problem prominence, and we do that even though, in terms of a tax gap, the larger portion of the tax gap is in individuals and an understatement of income, largely associated with schedule C, their own sort of business activities. We give that prominence because of the sense of fairness that is so important to average Americans. They can't feel that just because you're rich or you're a company you get away with it. So I'm with you a 100 percent on that and so is the President in terms of the allocation of resources.

BUSINESS SYSTEMS MODERNIZATION

BSM. I think there's a risk here that the committee is drawing the wrong impression. I do not disagree at all that this has been a troubled program, and it's tempting to say let's cut that program down to a \$100 million or put further controls on it. That would, in my view, be exactly the wrong thing to do. We are just now getting a handle on this. We're just now delivering the systems. I think that the problems that Inspector General stated are absolutely correct, but that was a view from 2 years ago. We've acted and we are turning a corner here and if we act as if nothing has happened then you will choke it off and then we really will be at risk of this system cratering because we won't move forward. These fiscal pressures as you know, Senator, are not going to get any easier. If we don't invest in this technology, you won't get the services. Right now we're at over 50 percent of the returns being filed electronically. That is good news. It helps everybody. If we don't keep going on this—hold me accountable to do it right for sure—but if we don't continue to have a baseline of funding—and this \$200 million is a very modest amount compared to where we were at \$400 million or \$500 million just 2 or 3 years ago—I fear we will really not make it.

Senator DORGAN. Mr. Chairman, could I just observe that if you are always turning a corner you may be going in a circle. The reason I say that and Mr. Everson I want you to succeed and I want to work with you and be helpful to you but for 8 years working on this subcommittee or some derivation of it, I've been told by Commissioners we're turning the corner. At some point it is apparently a track that we're on. So I guess in the final analysis, Mr. George, your work is very important. You tell us exactly what's happening down there. Mr. Everson, we want you to succeed. This is not criticism. It is frustration. So, Mr. Chairman, thank you for allowing me that therapy.

Senator BOND. Senator Dorgan, I hope you feel better.

Senator DORGAN. Much better. Thank you.

Senator BOND. We look forward to hearing your suggestions how we can make sure we're turning the corner in the right direction based on your experience. Senator Murray.

Senator MURRAY. Thank you very much. Mr. Chairman, I have a Veteran's Committee hearing that I want to get to so let me just ask you a quick question on the tax gap. Are there any findings in your report that are going to cause you to change your area of emphasis on enforcement?

COMPLIANCE BUDGET

Mr. EVERSON. I would say that we've looked at this and the results are preliminary, Senator. We're going to be refining them over the course of the year. That is why we've established this range. The statisticians are continuing to go through all of these areas. I have been struck by the fact that our allocation of resources is generally consistent with what we're seeing in the gap. You can see that we're asking for more money. Last year we didn't really touch individuals and small businesses very much compared to the high income and the corporation. This year in the request

we're starting to move past those two areas to cover that area more—that is where the big preponderance of the gap is. And so I think what we're doing here is generally consistent. The final point I would make for you to consider is that we've got two buckets of money: criminal activity and the tax-exempt area. They're not as directly tied to the gap. It's very tempting for the committee to just fund the things that get you the very best return, but we have other responsibilities, like maintaining the integrity of tax exemption, that are very important too. So while I think our resource allocation is consistent with the findings, we have to make sure we go beyond just the tax cap.

Senator MURRAY. Okay. Thank you very much. Thank you, Mr. Chairman. I appreciate it.

Senator BOND. Thank you very much, Senator Murray. I believe that we do need to support via some funding but we need clear benchmarks and requirements. We need a plan to lay out a straight path forward, so we know we're getting there. Mr. George, I'm sure, will be all over it to help us to determine that we're on that right path. TIGTA reported that the Security Audit and Analysis System that was developed to audit online activity of IRS employees was accepted by IRS even though its required functions IRS paid for were not operating. How much did it cost? What weaknesses still exist? And what are you doing to make the system work as advertised?

IT SECURITY

Mr. EVERSON. IT security is an issue of paramount concern for us. It is something that we've recognized. After I arrived at the agency, we stripped out our security functions from a variety of pockets in the agency and put together one mission assurance organization. One of my two deputies gives it the appropriate providence. I think that is bearing results. We've never had any penetrations from the outside of the IRS into our systems. TIGTA has correctly pointed out, as have others, that when you're inside the system there's maybe too much latitude, and we do have some problems where things can get compromised from time to time. We're working on that. We need to address it further. I think we're making progress. All I can tell you is that it is the subject of regular conversations at the most senior levels. So we're not going to move off this. We're going to continue to give it the prominence it needs because we don't want the security compromised. We recognize the terrible ramifications of that.

Senator BOND. So you're telling me that we saw this theft of personal information from ChoicePoint by criminals accessing data, posing as legitimate users, but you're telling me that nobody has been able, from the outside, to access the IRS system? It is not vulnerable to similar attack?

Mr. EVERSON. That is correct. Now I don't want to sound overconfident about that. But we have really good people who continue to work on that. People try to penetrate the system, Senator, from around the world everyday, but we've got good firewalls there. And we're going to continue to be vigilant to make sure we're doing absolutely everything we can to prevent that. I think TIGTA would

certainly say within the firewalls we've got some more work to do as well.

Senator BOND. I was kind of concerned when TIGTA called 100 IRS managers and employees pretending to be help desk employees, and they were able to convince 35 managers and employees to reveal their account name and change their passwords to one suggested by TIGTA. Doesn't that show the likelihood of defeating security measures? What can be done to make sure that that problem does not recur?

Mr. EVERSON. That's exactly the kind of thing I'm saying internally, within the firewalls, and we're obviously moving forward on a lot of what's in that report, and other measures. I think it is an area of continuing discussion and there's a lot of focus from TIGTA as we move forward on their stuff.

Senator BOND. Mr. George, what's your comments on that?

Mr. GEORGE. Well, Senator first of all to quote former Commissioner Sheldon Cohen, he thinks he is an honest man who has never been given the opportunity to cheat. And in effect that there are opportunities, that additional firewalls were maintained. Yes that would enhance the strength, in terms of outside attempts. But there's no question that internal access by disgruntled employees, it's a great risk to the IRS. And now that the Commissioner has restated his commitment to address that, I am more optimistic that something will and can be done. But it is something that TIGTA certainly will be monitoring, and we'll report back to you on.

Senator BOND. Thank you, Mr. George. Well, the Taxpayer Service Budget, Commissioner, assumes a reduction of \$134 million through taxpayer service reengineering. Until this week, however, we had not received details on how the IRS plans to achieve these savings. The Taxpayers Advocate's testimony, as you know, said increasing enforcement and reducing service is based on more of an instinct than solid research. Can you lay out for us, and give us further detail, for the record, if that's appropriate, on how you arrive at these proposed cuts. We've had some discussions—

TAXPAYER SERVICE REENGINEERING

Mr. EVERSON. I'm absolutely happy to do that. We've had a long process of 2 or 3 months of detailed planning and weighing of options. And I think it is a sound proposal and we will provide you those details.

[The information follows:]

TAXPAYER SERVICE FISCAL YEAR 2006 BUDGET REDUCTION INITIATIVES

ASSISTANCE

Closing selected Taxpayer Assistance Centers realigns service with changing trends.—TACs are one of the most expensive methods of customer service. The number of people accessing TACs continues to decline as more taxpayers use the IRS toll-free telephone system to get answers to their questions. Web-site use and e-filing continues to rise. Volunteer tax preparation and other outreach assistance is also increasing. The IRS created a business model based on five neutral criteria to identify the most appropriate TACs to close. Based on internal and external input on the model, taxpayer-centric needs, such as workload, geography, and demographics were given greater weight than labor and facilities costs. The estimated savings are \$45 million–\$55 million.

Changing the Toll-Free Telephone Hours of Operation.—The hours of toll-free telephone operations will change beginning October 2005 from 15 to 12 hours 8:00 a.m.

to 8:00 p.m., Monday through Friday, in local time zones. Current call volume is low during the late evening and early morning. Ninety-three percent of the calls come in from 8 a.m. to 8 p.m. The change in level of service is minimal. The estimated savings are \$10 million–\$16 million.

IRS will reduce Electronic Tax Law Assistance (ETLA) service.—The IRS will reduce the level of service in fiscal year 2006. Less than 150,000 tax law inquiries were received in fiscal year 2004. This compares with over 8.6 million tax law inquiries handled via our toll-free lines. The IRS will discontinue providing ETLA in early fiscal year 2006 for customers living in the United States. ETLA will continue for customers located overseas (Taxpayers living abroad and Military Personnel) because this is their only toll-free communication tool. The estimated savings are still being evaluated but is less than \$1 million.

The IRS is closing non-continuing call-sites.—The IRS will consolidate work in its Boston, Chicago, Des Moines, Houston, Omaha, and Wichita telephone call-sites into its larger phone centers for greater efficiency and lower costs. The change will be invisible to customers. Taxpayers won't notice a change; their calls are currently routed and answered nationwide. The IRS has 26 call-sites nationwide—these six non-continuing sites are satellites of the 26 sites. Nationwide the IRS has approximately 15,000 employees providing customer service. Savings from staff realignment have not yet been finalized. Rent savings of up to \$1.2 million will be achieved primarily in fiscal year 2007.

Updates in processing of applications for Employer ID numbers submitted through the Internet.—The IRS will complete upgrades to its system for accepting applications through the Internet for employer identification numbers (EINs). The current system for accepting the EIN applications at the front-end of the process is automated. This will improve back-end processing of the applications. By September 2006, 100 percent of the forms submitted through the Internet should be fully automated. The estimated savings are \$2 million–\$5 million.

Efficiencies in managing customer accounts will result in savings.—The process improvements and productivity gains achieved over the past few years, along with the decline in correspondence from taxpayers who have account or tax law inquiries, have changed the need for the same staff levels. The estimated savings are \$15 million–\$17 million.

OUTREACH

Greater efficiencies in distributing tax products, increases in e-filing and use of Internet to download tax products will decrease printing and postage costs.—For example: The IRS's forms distribution site will be more efficient and save staff, printing and postage resources as a result of consolidating operations from three sites to one site. Other savings include mailing out fewer tax packages because more taxpayers are filing electronically. The IRS will reduce excess quantities of tax products based on increases in e-filing and internet downloads of tax forms and publications, and by streamlining some tax products. The estimated savings are \$5 million–\$10 million.

Discontinuing lower value products in outreach programs and reducing some program travel will have little affect on customers.—IRS will discontinue developing some lower value publications and outreach material used to support volunteer tax assistants and outreach partners. For example, the IRS will discontinue some small quantities of end-of-season flyers, brochures and pamphlets used by its field staff, and reduce some operational travel. The estimated savings are up to \$1 million.

Realigning and refocusing communications, outreach, and liaison efforts within the Small Business/Self-Employed (SB/SE) Division.—The merger will improve service to small business taxpayers and tax professionals, clarify the individual missions, coordinate programs, and minimize any overlapping responsibilities. Efficiencies gained through the realignment will allow the IRS to redirect staff resources to front line enforcement efforts. The estimated savings are \$15 million–\$20 million.

PROCESSING

IRS will discontinue TeleFile.—The IRS will end its TeleFile program after August 16, 2005. TeleFile allows taxpayers to file certain forms by telephone: Form 1040EZ, Income Tax Return for Single Filers and Joint Filers with No Dependents; Certain State individual tax returns, Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, and Form 941, Employer's Quarterly Federal Tax Return. Decline in use for most forms (e.g., less than 4 million of the 16 million eligible EZ filers used TeleFile), coupled with increasing costs to maintain the system, and the growth of other electronic filing options led to the

decision to end the program. The expected printing and postage savings is \$4 million–\$5 million.

Improved efficiencies in processing tax returns.—The IRS will have additional savings due to improved efficiencies in its Service Center campus processing operations, through re-engineering of its processes, and because more taxpayers are e-filing or using computer software to prepare their tax returns. For example: The IRS is evaluating its current processing procedures so that it can reduce unnecessary labor costs, especially when the returns are prepared by taxpayers and practitioners using computer software. The IRS will improve its productivity rates in data transcription of data from the forms. The expected savings are \$9 million–\$12 million.

Enhancements to processing of paper Forms 941 will improve productivity.—The IRS will modify its existing Service Center Recognition/Image Processing System (SCRIPS) to add a new application for processing paper Employer's Quarterly Federal Tax Return, Forms 941. This will result in improved productivity rates and increased accuracy in data capture. Fewer additional seasonal employees will be needed. The estimated savings are \$4 million–\$6 million.

Senator BOND.—We would also like to have Mr. George's review of it so we can take a look at it.

You've already discussed the criteria that you're considering to close Taxpayer Assistance Centers. And you have not, as I understand it, made a determination which of the, on the blue chart, which methodology you're going to use.

Mr. EVERSON. That's correct. I think we're leaning towards the option No. 1, which has the impact of the smaller number of sites being closed. But we're still assessing that over the next coming weeks.

Senator BOND. All right. The tax gap you mentioned—how did you calculate the \$4 received for every dollar of enforcement spending?

RETURN ON INVESTMENT

Mr. EVERSON. The chart that you saw there of enforcement revenues, that's a pretty simple thing. We track the collections, which is the bulk of this money. We've got a small strip, a couple of billion dollars of monies that come in from document matching activities. And then the rest is from our audits. And we follow how much money comes in from each of those actions. And now that is turning back up, that is a comparison. That \$43 billion, that's cash in hand. And that compares, as I said, to the total budget that you've given us of \$10.2 billion. It's a gross simplification. The \$10.2 includes the \$6 plus billion for enforcement, but also all the other money for processing returns or answering phones, or the outreach that we do. And I'm simply pointing out to everybody that you get \$4:\$1 on average. Now you get better than that, obviously, if you look only at enforcement programs.

Senator BOND. If you took the audit function and the enforcement function alone, you might get a higher number?

Mr. EVERSON. You would get a higher number, and what we try to do, Senator is run a balanced program here. We could invest in certain strips of activity that would get you \$10:\$1 or \$20:\$1, but then you would be ignoring other areas. And you'd be, maybe, going after more middle class people just on under reporting as opposed to trying to run a balanced system, where you go across that whole tax gap map. If you look at the tax gap map there are a lot of activities in there that you have to get after. And you have to show some enforcement presence across everything.

Senator BOND. Mr. George, do you have any input on those figures?

Mr. GEORGE. We're in the process now, Senator, of evaluating the methodology and the conclusions that you heard the Commissioner state. And so we will issue that report as soon as we can. And we'll give that to you.

Mr. EVERSON. That \$43 billion in the methodology has been audited by GAO years ago when that system was set up. So I think the integrity of that number is pretty well established.

Senator BOND. Mr. George, as related by Senator Dorgan, your oversight of the VITA program had some pretty stunning results. Out of 35 VITA returns, they were zero for 35 in accuracy, which doesn't get you into a higher league certainly if you're batting zero. Did you present particularly difficult returns? How did you structure this?

Mr. GEORGE. Senator, there's no question that the complexity of tax law is a factor. And so that then leads to the degree to which VITA volunteers are trained. So we do have some question as to whether or not that is being effectively done. Lastly, volunteers did not in effect follow normal procedures in many instances. Some of the mistakes that were made could have been avoided had they, for example used intake sheets properly and were supervised properly. The problems we found are something that we don't believe are insurmountable. Again, through proper training and through appropriate oversight. We think many of the problems could be avoided in the future.

Senator BOND. Commissioner, what do you propose to do to fix that problem?

VITA PROGRAM

Mr. EVERSON. Let me make a couple comments on this. I think that in response to your question, were these overly complex returns, the answer is yes. And in fact TIGTA is looking at this year, I believe both parties agree—and the Inspector General wouldn't notice because he wasn't here last year—a more representative sampling of the returns. It does not yield, based upon the work that is being done now, a good return or a good rate, but it doesn't yield a zero either. So I think that the change in the methodology of how the returns have been selected shows an improvement. Now we have taken their recommendations and are working on them with one exception. We've done more training; we're working on the software, and the whole series of things. We're making sure people are using the guide. There was some contention around one suggestion, and we backed away from the proposal, that we have IRS observers doing more onsite monitoring. We probably will end up doing this in the next filing season when we satisfy ourselves that it can be handled with the appropriate disclosure discussion with taxpayers before we do it. They had recommended that step. The Taxpayer Advocate felt that it was not an appropriate step. The volunteer organizations themselves, who do the bulk of this work, have told me that they think it is good idea. AARP, which does about half of this work, they told me they were fine with having IRS people there to watch what was going on. So I think we want to do that down the road, having organized it correctly. So we have

a lot more to do here. To strengthen this area, I think what they're doing is helpful to us. And they're refining what they do and we're refining what we do. And we've got to do better.

Senator BOND. IRS estimates that 740,000 people have set up offshore financial accounts, concealing taxable income at a loss of \$20 to \$40 billion a year. When you had a voluntary compliance initiative, only 1,300 of them came forward. How can you shut down this abusive practice? And what realistically can you do about it to go after the other 738,000-some-odd taxpayers who are non-taxpayers?

OFFSHORE VOLUNTARY COMPLIANCE INITIATIVE

Mr. EVERSON. I think that this offshore area is particularly troublesome and difficult. Basically augmenting those resources going back in to the offshore compliance and audit rate, that helps sweep in more of these taxpayers. We do look at returns. We have access to other information; we see how people are spending their money. If we see things that are out of line maybe we can get after this in other ways. But the other thing is we're getting better cooperation from other countries. We've had some issues with getting all of the information we need from credit card providers and others. But we're working through those. It is a big, big continuing challenge, internationalization and sending money offshore. It goes beyond what Senator Dorgan was saying on corporations. It really does go into individuals too. And what we have is a very aggressive program with the Justice Department to get injunctions against promoters if we see schemes that are being sold to people. We attack them and try to leverage our findings from the promoters as well.

Senator BOND. Many of the questions we raised really deal with the complexity of the IRS code. With 54,000 pages of tax law regulation and related advisory material, I think we all agree it is too complex, confusing, and costly. What can be done administratively to simplify it? And does the administration have specific legislative changes to reduce the complexity, to assist taxpayers and assist in enforcement?

TAX COMPLEXITY

Mr. EVERSON. I've testified before the Tax Panel that has been formed, as you know, with your former colleagues Senators Mack and Breaux. And I've said that the simplification is terribly important. Our view is that complexity obscures understanding. People either make inadvertent errors or they throw up their hands and say "Why bother?" at a certain point. On the other hand the complexity provides an opportunity for those who would skirt the tax laws to hide and to avoid detection by the IRS. So I agree with your sentiment 100 percent. I've said to the tax panel that compliance is something that they need to watch for when they come forward with proposals that you will ultimately see. We need to look at compliance. A couple of quick points: no system is immune to compliance issues. So you've got to consider its administerability. Look at a VAT as an example. We were in Britain a few months ago and they've got an 11 or 12 percent compliance problem with the VAT system, so you have to be cognizant of these problems, no

matter what system you chose. And the administration is, I think, well aware of that, as is the tax panel as they go through these discussions.

Senator BOND. A final question. Some small business tax preparers are concerned and I wonder whether the IRS has any plans to charge fees for those who can afford them for some of IRS's services, especially where there are competing services provided by the private sector. Is it feasible to consider charging fees where it is obvious that the taxpayers, if not for getting IRS service, would be using private sector tax preparers?

FEES FOR SERVICE

Mr. EVERSON. We have something like 1.2 million tax practitioners out there that we're highly relying on. The IRS doesn't do all the work and it doesn't do all the contacts with the individuals. We rely on professionals, good professionals in lots of small firms to help us guide people through the process. I'm unaware at this time of any new fee proposals along the lines of what you've suggested. And I'll check to see what the status is and let you know. But we think the vitality of small practitioners is very central to what we're doing.

Senator BOND. Mr. George, any closing comments?

Mr. GEORGE. Senator, again thank you for the opportunity. This being my first hearing in my new capacity as IG. There is no question of the vital role that the Internal Revenue Service plays to our Nation's security. And I have known of Mark Everson and have worked with him in his capacity as managing official at OMB.

Mr. EVERSON. That's why he's skeptical.

Mr. GEORGE. Not at all, not at all. So I believe that he is committed to helping ensure that this important organization fulfills its mandate. And I can assure you that I'm committed to assisting in terms of tax administration and ensuring that that organization does what it's supposed to do. And if it engages in activity that's inappropriate, that we bring that to both your attention and to the attention of the Secretary of the Treasury.

Senator BOND. Thank you, Mr. George. Commissioner, any closing comments?

Mr. EVERSON. No. I appreciate your interest. We're in tough territory here; you've got some other needy clients. I ask you to bear in mind that we feel we've constructed a balanced proposal. But that getting this enforcement funding does help the government's top line. And that's obviously of some very real importance in this time of deficits.

ADDITIONAL SUBMITTED STATEMENTS

Senator BOND. Additional prepared statements have been submitted, and they will also be included in the record.

[The statements follow:]

PREPARED STATEMENT OF JAMES R. WHITE, DIRECTOR, STRATEGIC ISSUES, AND
DAVID A. POWNER, DIRECTOR, INFORMATION TECHNOLOGY MANAGEMENT ISSUES,
GOVERNMENT ACCOUNTABILITY OFFICE

INTERNAL REVENUE SERVICE—ASSESSMENT OF THE FISCAL YEAR 2006 BUDGET REQUEST

GAO HIGHLIGHTS

Highlights of GAO-05-566, a statement for the record for the Subcommittee on Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies, Committee on Appropriations.

WHY GAO DID THIS STUDY

The Internal Revenue Service (IRS) has been shifting its priorities from taxpayer service to enforcement and its management of Business Systems Modernization (BSM) from contractors to IRS staff. Although there are sound reasons for these adjustments, they also involve risks.

With respect to the fiscal year 2006 budget request, GAO assessed (1) how IRS proposes to balance its resources between taxpayer service and enforcement programs and the potential impact on taxpayers, (2) status of IRS's efforts to develop and implement the BSM program, and (3) the progress IRS has made in implementing best practices in developing its Information Technology (IT) operations and maintenance budget.

WHAT GAO RECOMMENDS

In a related statement (GAO-05-416T), GAO recommended that the Commissioner of Internal Revenue supplement the 2006 budget request with more detailed information on how proposed service reductions would impact taxpayers. GAO has recommendations still outstanding related to BSM management controls and IT budget justification.

WHAT GAO FOUND

IRS's fiscal year 2006 budget request of \$10.9 billion is an increase of 3.7 percent over last year's enacted levels. This includes an 8 percent increase for enforcement, and a 1 percent and 2 percent decrease for taxpayer service and BSM. However, the potential impact of these changes on taxpayers in either the short- or long-term is unclear, because IRS has not provided details of proposed taxpayer service reductions, and although it is developing long-term goals, they are not yet finalized. Because of the proposed reductions and new and improved taxpayer services in recent years, this is an opportune time to examine the menu of services IRS provides. It may be possible to maintain the overall level of service to taxpayers by offsetting reductions in some areas with new and improved service in other areas such as on IRS's Web site.

Taxpayers and IRS are seeing some payoff from the BSM program, with the deployment of initial phases of several modernized systems in 2004. Nevertheless, the BSM program continues to be high-risk, in part, because projects have incurred significant cost increases and schedule delays and the program faces major challenges in areas such as human capital and requirements management. As a result of budget reductions and other factors, IRS has made major adjustments. It is too early to tell what effect these adjustments will have on the program, but they are not without risk and could potentially impact future budgets. Further, the BSM program is based on strategies developed years ago, which, coupled with the delays and changes brought on by budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. Because of these challenges, IRS is redefining and refocusing the BSM program.

Likewise, IRS has made progress in implementing best practices that would improve its budget development and support for its IT operations and maintenance request. In particular, the recent release of a modernized financial management system included a cost module. However, at this time, historical data is not yet available for IRS to use this module in formulating its IT operations and maintenance request.

IRS BUDGET SUMMARY FOR KEY ACTIVITIES, FISCAL YEARS 2004–2006

[Dollars in millions]

	Fiscal Year 2004 (Enacted)	Fiscal Year 2005 (Enacted)	Fiscal Year 2006 (Request)	Percent Change (2004– 2005)	Percent Change (2005– 2006)	Percent Change (2004– 2006)
Taxpayer service	\$3,710	\$3,606	\$3,567	– 2.8	– 1.1	– 3.8
Enforcement	6,052	6,392	6,893	5.6	7.8	13.9
BSM	388	203	199	– 47.6	– 2.0	– 48.7

Source.—GAO analysis of IRS data.

Note.—Numbers may not add due to rounding.

Mr. Chairman and members of the subcommittee, we are pleased to present this statement for the record regarding the Internal Revenue Service's (IRS) fiscal year 2006 budget request and in support of your April 7, 2005 hearing on IRS's appropriations.

IRS is in the midst of making significant adjustments to its modernization strategy to better serve taxpayers and ensure their compliance with the Nation's tax laws. It is now 7 years since the passage of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98)¹ and IRS is shifting its priorities from improving taxpayer service to strengthening tax law enforcement efforts. IRS is also adjusting its strategy for managing its Business Systems Modernization (BSM) effort by shifting significant program management responsibilities from contractor to IRS staff. Although there are sound reasons for these adjustments, they also involve risk.

We have reported that IRS has made progress improving taxpayer service since the passage of RRA 98.² For example, IRS's telephone assistance is now more accessible and accurate. Further, IRS is more efficient at processing tax returns, in part, because of the growth of electronic filing, and has cut processing staff. IRS has also implemented some modernized information systems and increased its capacity to manage large systems acquisition and development programs. However, progress has not been uniform. We have reported on large and pervasive declines in IRS's tax law enforcement programs after 1998. We have also reported that a number of systems modernization projects were over budget and behind schedule.³

As noted, IRS is shifting its priorities to better address these problems. The risk, as IRS shifts its priorities towards enforcement, is that some of the gains in the quality of taxpayer service could be surrendered. There are analogous risks associated with moving more of the management of BSM in-house.

With these risks in mind, our statement for the record discusses IRS's fiscal year 2006 budget request. To address your request to provide this statement, we assessed (1) how IRS proposes to balance its resources between taxpayer service and enforcement programs and the potential impact on taxpayers, (2) the status of IRS's efforts to develop and implement the BSM program, and (3) the progress IRS has made in implementing best practices for developing its information technology (IT) operations and maintenance budget.

Our assessment of the budget request and BSM is based on a comparative analysis of IRS's fiscal year 2002 through 2006 budget requests, funding, expenditures, other documentation, and interviews with IRS officials. For this assessment, we used historical budget and performance data from reports and budget requests used by IRS, Department of Treasury, and Office of Management and Budget (OMB). In past work, we assessed IRS's budget and performance data.⁴ Since the data sources and procedures for producing this year's budget data have not significantly changed from prior years, we determined that the data were sufficiently reliable for the purposes of this report although for fiscal years 2005 and 2006 subject to change. Regarding our analysis of IRS's BSM program, we primarily used the agency's BSM expenditure plans to determine the status of the program. To assess the reliability of the cost and schedule information contained in these plans, we interviewed appli-

¹ Public Law No. 105–206 (1998).

² See for example, GAO–05–67, Tax Administration: IRS Improved Performance in the 2004 Filing Season, But Better Data on the Quality of Some Services Are Needed (Washington, DC: Nov. 15, 2004).

³ GAO, Internal Revenue Service: Assessment of Fiscal Year 2005 Budget Request and 2004 Filing Season Performance, GAO–04–560T (Washington, DC: Mar. 30, 2004).

⁴ GAO, Tax Administration: IRS Needs to Further Refine Its Tax Filing Season Performance Measures, GAO–03–143 (Washington, DC: Nov. 22, 2002) and GAO, Financial Audit: IRS's Fiscal Years 2004 and 2003 Financial Statements, GAO–05–103 (Washington, DC: Nov. 10, 2004).

cable IRS officials to gain an understanding of the data and discuss our use of that data. In addition, we checked that information in the plans was consistent with information contained in IRS internal briefings. Accordingly, we determined that the data in the plans were sufficiently reliable for purposes of this statement. We performed our work in Washington, DC and Atlanta, Georgia from December 2004 through March 2005, in accordance with generally accepted government auditing standards.

In summary, our assessment shows that:

- IRS's 2006 fiscal year budget request reflects a continuing shift in priorities from improving taxpayer service to strengthening enforcement efforts, but the potential impact of these changes on taxpayers in both the short- and long-term is unclear. IRS is requesting \$10.9 billion, an increase of 3.7 percent over fiscal year 2005 enacted levels. This includes an 8 percent increase for enforcement, and a 1 percent and 2 percent decrease for taxpayer service and BSM, respectively. IRS has not finalized the details on where reductions in taxpayer service would occur. In addition, IRS is developing, but currently lacks, long-term goals that can help IRS inform stakeholders, including the Congress, and aid them in assessing performance and making budget decisions. In light of the current budget environment and IRS's improvements in taxpayer service over the last several years, this is an opportune time to reconsider the menu of services it provides. It may be possible to maintain the overall level of assistance to taxpayers by changing the menu of services offered, offsetting reductions in some areas with new and improved service in other areas such as on IRS's Web site.
- IRS has taken important steps forward towards implementing the BSM program by delivering the initial phases of several modernized systems in 2004 and early 2005. Nevertheless, BSM continues to be high risk because, in part, its projects have incurred significant cost increases and schedule delays, and the program continues to face major challenges. As a result of funding reductions and other factors, IRS has made major adjustments to the BSM program, including reducing the management reserve and changing the mix and roles of contractor versus Federal staff used to manage the program. It is too early to tell what effect these adjustments will ultimately have on the BSM program, but they are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and taxpayers. Finally, the BSM program is based on visions and strategies developed years ago, which, coupled with the already significant delays the program has experienced and the changes brought on by the budget reductions, indicates that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM, including an assessment of when significant future BSM functionality would be delivered. According to the Associate Chief Information Officer (CIO) for BSM, IRS is redefining and refocusing this program.
- IRS has made progress toward implementing investment management best practices that would improve its budget development and support for its IT operations and maintenance funding requests. For example, the recent release of a new accounting system included an activity-based cost module, which IRS considered to be a necessary action to implement these best practices. However, Office of the Chief Financial Officer officials stated that IRS needs 3 years of actual costs to have the historical data necessary to provide a basis for future budget estimates. Accordingly, they expect that IRS will begin using the activity-based cost module in formulating the fiscal year 2008 budget and will have the requisite 3 years of historical data in time to develop the fiscal year 2010 budget.

IRS'S BUDGET REQUEST CONTINUES TO SHIFT PRIORITY FROM TAXPAYER SERVICE TO ENFORCEMENT, BUT THE SHORT- AND LONG-TERM IMPACTS ON TAXPAYERS ARE UNCLEAR

IRS's fiscal year 2006 budget request reflects a continuing shift in priorities by proposing reductions in taxpayer service and increases in enforcement activities. The request does not provide details about how the reductions will impact taxpayers in the short-term. Nor does IRS have long-term goals; thus the contribution of the fiscal year 2006 budget request to achieving IRS's mission in the long-term is unclear. Because of budget constraints and the progress IRS has made improving the quality of taxpayer services, this is an opportune time to reconsider the menu of services IRS offers.

IRS Is Proposing Reductions in Taxpayer Service and BSM and Increases in Enforcement

IRS is requesting \$10.9 billion, which includes just over a 1 percent decrease for taxpayer service, a 2 percent decrease for BSM, and nearly an 8 percent increase for enforcement, as shown in table 1.⁵ As table 1 further shows, the changes proposed in the 2006 budget request continue a trend from 2004. In comparison to the fiscal year 2004 enacted budget, the 2006 budget request proposes almost 4 percent less for service, almost 49 percent less for BSM, and nearly 14 percent more for enforcement.⁶

TABLE 1.—IRS BUDGET SUMMARY FOR KEY ACTIVITIES, FISCAL YEARS 2004–2006

(Dollars in millions)

	Fiscal Year 2004 (Enacted)	Fiscal Year 2005 (Enacted)	Fiscal Year 2006 (Request)	Percent Change (2004– 2005)	Percent Change (2005– 2006)	Percent Change (2004– 2006)
Taxpayer service	\$3,710	\$3,606	\$3,567	– 2.8	– 1.1	– 3.8
Enforcement	6,052	6,392	6,893	5.6	7.8	13.9
BSM	388	203	199	– 47.6	– 2.0	– 48.7

Source.—GAO analysis of IRS data.

Note.—Numbers may not add due to rounding.

As table 1 also shows, taxpayer service sustained a reduction of \$104 million or 2.8 percent between fiscal years 2004 and 2005. According to IRS officials, the majority of this reduction was the result of consolidating paper-processing operations, shifting resources from service to enforcement, and reducing some services. IRS officials said that this reduction is not expected to adversely impact the services they provide to taxpayers but added that the agency cannot continue to absorb reductions in taxpayer service without beginning to compromise some services.

For fiscal years 2005 and 2006, table 2 shows some details of changes in both dollars and full-time equivalents (FTE).⁷ Both are shown because funding changes do not translate into proportional changes in FTEs due to cost increases for salaries, rent, and other items. For example, the \$39 million or 1.1 percent reduction in taxpayer service translates into a reduction of 1,385 FTEs or 3.6 percent. Similarly, the over \$500 million or 7.8 percent increase in enforcement spending translates into an increase of 1,961 FTEs or 3.4 percent.

TABLE 2.—IRS REQUESTED CHANGES IN FUNDING FOR TAXPAYER SERVICE AND ENFORCEMENT, FISCAL YEARS 2005 AND 2006 (REQUESTED)

(Dollars in millions)

Program Activities	Fiscal Year 2005 (Estimated)		Fiscal Year 2006 (Requested)		Change Fiscal Year 2005–Fiscal Year 2006	
	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents
Assistance	\$1,829	20,798	\$1,806	20,160	– \$23	– 638
Outreach	\$500	2,473	\$466	1,905	– \$34	– 568
Processing	\$1,276	15,695	\$1,295	15,516	\$19	– 179
Taxpayer service subtotal	\$3,606	38,966	\$3,567	37,581	– \$39	– 1,385
Research	\$154	1,119	\$158	1,119	\$4	0
Examination	\$3,478	31,498	\$3,712	32,284	\$234	786
Collection	\$1,826	18,023	\$1,991	18,815	\$165	792

⁵ IRS is proposing a new budget structure beginning in fiscal year 2006. The proposal would integrate support costs and the IT appropriation into taxpayer assistance and operations appropriation with eight program areas involving both taxpayer service and enforcement. See appendix I for information on the new budget structure.

⁶ The administration proposes to fully fund enforcement efforts and costs as contingent appropriations. This would be achieved by using one of two budgetary mechanisms that would allow for an adjustment to total discretionary spending for fiscal year 2006 of not more than \$446 million for IRS tax enforcement.

⁷ According to IRS, an FTE is the equivalent of one person working full time for 1 year without overtime.

TABLE 2.—IRS REQUESTED CHANGES IN FUNDING FOR TAXPAYER SERVICE AND ENFORCEMENT, FISCAL YEARS 2005 AND 2006 (REQUESTED)—Continued
[Dollars in millions]

Program Activities	Fiscal Year 2005 (Estimated)		Fiscal Year 2006 (Requested)		Change Fiscal Year 2005-Fiscal Year 2006	
	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents
Investigation	\$682	4,899	\$767	5,250	\$85	351
Regulatory	\$253	1,912	\$265	1,944	\$12	32
Enforcement subtotal	\$6,392	57,451	\$6,893	59,412	\$500	1,961
Taxpayer service and enforcement total	\$9,998	96,417	\$10,460	96,993	\$462	576

Source.—GAO analysis of IRS data.

Note.—Numbers may not add due to rounding.

The difference between changes in dollars and FTEs could be even larger because of unbudgeted expenses. Unbudgeted expenses have consumed some of IRS's budget increases and internal savings increases over the last few years. Unbudgeted expenses include unfunded portions of annual salary increases, which can be substantial given IRS's large workforce, and other costs such as higher-than-budgeted rent increases. According to IRS officials, these unbudgeted expenses accounted for over \$150 million in each of the last 4 years.

An IRS official also told us they anticipate having to cover unbudgeted expenses in 2006. As of March 2005, IRS officials were projecting unbudgeted salary increases of at least \$40 million. This projection could change since potential Federal salary increases for 2006 have not been determined.

IRS Is Proposing \$39 Million Less for Taxpayer Service, but the Impact on Taxpayers Is Unclear

The budget request provides some detail on how IRS plans to absorb cost increases in the taxpayer service budget. IRS is proposing a gross reduction of over \$134 million in taxpayer service from reexamining the budget's base and plans to use more than \$95 million of it to cover annual increases such as salaries. This leaves a net reduction of nearly \$39 million or 1.1 percent in the taxpayer service budget. The extent to which IRS is able to achieve the gross reductions will impact its ability to use the funds as anticipated.

Decisions on how the \$134 million gross reduction would be absorbed were not finalized prior to releasing the budget. According to IRS officials, some of the reductions would result from efficiency gains such as reducing printing and postage costs; however, others would result from reductions in the services provided to taxpayers such as shortening the hours of toll-free telephone service operations. The officials also said most decisions have now been made about general areas for reduction and most changes will not be readily apparent to taxpayers.

Although IRS has made general decisions about the reductions, many of the details have yet to be determined. Therefore, the extent of the impact on taxpayers in the short term is unclear. For example, IRS plans to reduce dependence on field assistance, including walk-in sites, but has not reached a final decision on how to reduce services. Table 3 provides further detail on how IRS is proposing to reduce funding and resources for taxpayer service.

TABLE 3.—IRS REQUESTED CHANGES IN FUNDING AND FULL-TIME EQUIVALENTS FOR TAXPAYER SERVICE, FISCAL YEARS 2005 AND 2006
[Dollars in millions]

Program Activities	Fiscal Year 2005 (Actual)		Fiscal Year 2006 (Requested)		Change Fiscal Year 2005-2006	
	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents
Assistance:						
Electronic	\$1,536	17,745	\$1,557	17,721	\$21	— 24
Field	\$274	2,796	\$230	2,181	— \$44	— 615

TABLE 3.—IRS REQUESTED CHANGES IN FUNDING AND FULL-TIME EQUIVALENTS FOR TAXPAYER SERVICE, FISCAL YEARS 2005 AND 2006—Continued
[Dollars in millions]

Program Activities	Fiscal Year 2005 (Actual)		Fiscal Year 2006 (Requested)		Change Fiscal Year 2005–2006	
	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents	Dollars	Full-time Equivalents
EITC assistance	\$19	258	\$19	258	<\$1	.....
Assistance total	\$1,829	20,798	\$1,806	20,160	–\$23	–638
Outreach:						
Publication & Media	\$291	821	\$276	520	–\$15	–301
Taxpayer Education & Communication	\$203	1,592	\$184	1,326	–\$19	–266
EITC Outreach	\$7	60	\$7	60	<\$1	.....
Outreach total	\$500	2,473	\$466	1,905	–\$34	–568
Processing	\$1,276	15,695	\$1,295	15,516	\$19	–179
Taxpayer service total	\$3,606	38,966	\$3,568	37,581	–\$39	–1,385

Source.—GAO analysis of IRS data.

Note.—Numbers may not add due to rounding.

IRS Continues to Request Significant Increases for Enforcement to Build on Recent Hiring Gains

IRS's fiscal year 2006 budget request is the sixth consecutive year the agency has requested additional staffing for enforcement. However, up until last year, IRS was unable to increase enforcement staffing; unbudgeted costs and other priorities consumed the budget increase.

IRS's proposal for fiscal year 2006, if implemented as planned, would return enforcement staffing in these occupations to their highest levels since 1999. Of the more than \$500 million increase requested for 2006, about \$265 million would fund enforcement initiatives, over \$182 million would be used in part for salary increases, and over \$55 million is a proposal to transfer funding authority from the Department of Justice's Interagency Crime and Drug Enforcement. The \$500 million increase would be supplemented by internal enforcement savings of \$88 million. As is the case with taxpayer service savings, the extent to which IRS achieves enforcement savings will affect its ability to fund the new enforcement initiatives.

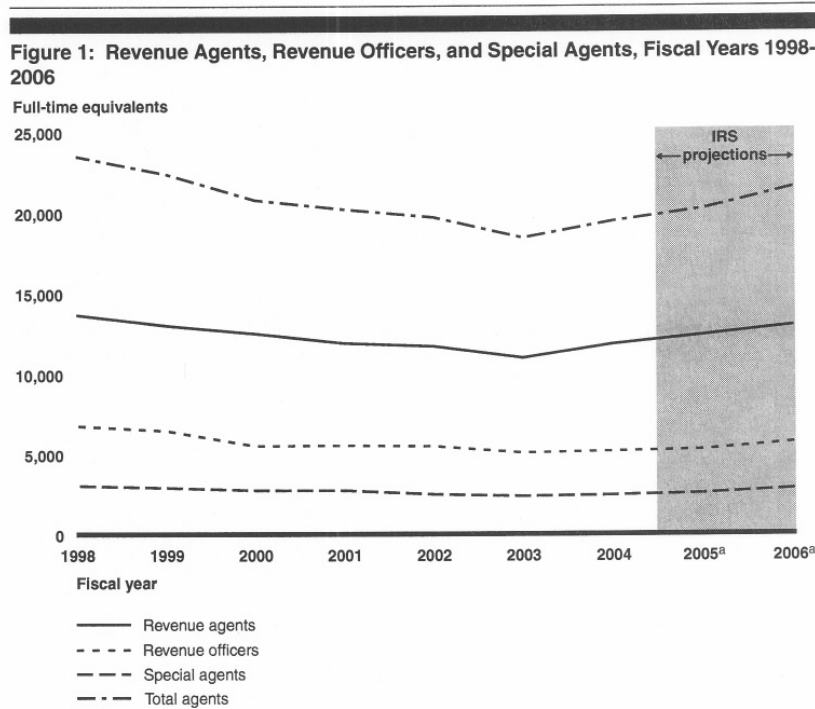
The \$265 million for new enforcement initiatives consist of:

- \$149.7 million and 920 FTEs to attack corrosive non-compliance activity driving the tax gap such as abusive trusts and shelters, including offshore credit cards and organized tax resistance;
- \$51.8 million and 236 FTEs to detect and deter corrosive corporate non-compliance to attack complex abusive tax avoidance transactions on a global basis and challenge those who promote their use;
- \$37.9 million and 417 FTEs to increase individual taxpayer compliance by identifying and implementing actions to address non-compliance with filing requirements; increasing Automated Underreporter resources to address the reporting compliance tax gap; increasing audit coverage; and expanding collection work in walk-in sites;
- \$14.5 million and 77 FTEs to combat abusive transactions by entities with special tax status by initiating examinations more promptly, safeguarding compliant customers from unscrupulous promoters, and increasing vigilance to ensure that the assets of tax-exempt organizations are put to their intended tax-preferred purpose and not misdirected to fund terrorism or for private gain; and
- \$10.8 million and 22 FTEs to curtail fraudulent refund crimes.

The \$88 million in internal savings would be reinvested to perform the following activities:

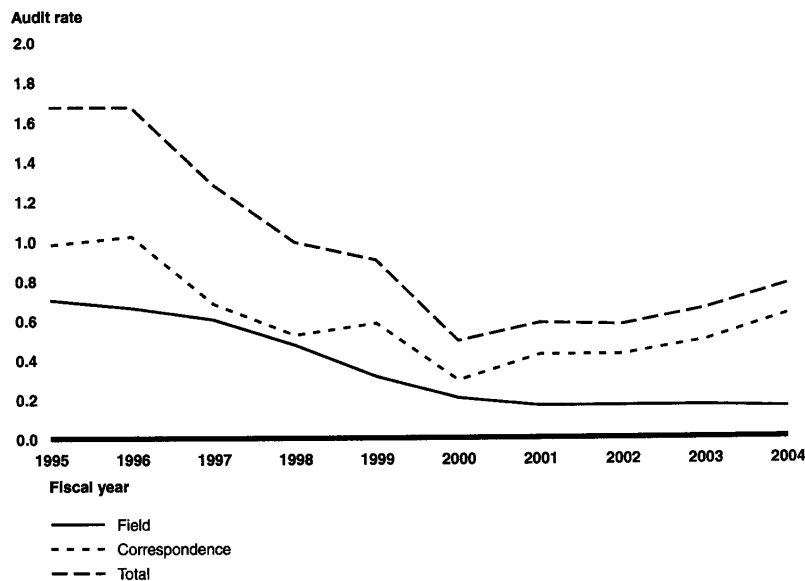
- \$66.7 million and 585 FTEs to devote resources to front-line enforcement activities;
- \$14.9 million and 156 FTEs to, in part, address bankruptcy-related taxpayer questions; and
- \$6.7 million and 52 FTEs to address complex, high-risk issues such as compliance among tax professionals.

In the past, IRS has had trouble achieving enforcement staffing increases because other priorities, including unbudgeted expenses, have absorbed additional funds. IRS achieved some gains in 2004 and expects modest gains in 2005. Figure 1 shows that the number of revenue agents (those who audit complex returns), revenue officers (those who do field collection work), and special agents (those who perform criminal investigations) decreased over 21 percent between 1998 and 2003, but increased almost 6 percent from 2003 to 2004.



IRS's recent gains in enforcement staffing are encouraging, as tax law enforcement continues to remain an area of high risk for the Federal Government because the resources IRS has dedicated to enforcing the tax laws have declined, while IRS's enforcement workload—measured by the number of taxpayer returns filed—has continually increased.⁸ Figure 2 shows the trend in field, correspondence, and total audit rates since 1995. Field audits involve face-to-face audits and correspondence audits are typically less complex involving communication through notices. IRS experienced steep declines in audit rates from 1995 to 1999, but the audit rate—the proportion of tax returns that IRS audits each year—has slowly increased since 2000. The figure shows that the increase in total audit rates of individual filers has been driven mostly by correspondence audits, while more complex field audits, continue to decline.

⁸ GAO, High Risk Series: An Update, GAO-05-207 (Washington, DC: January 2005).

Figure 2: Audit Rate of Individual Income Tax Returns, Fiscal Years 1995-2004

Source: GAO analysis of IRS data.

The link between the decline in enforcement staff and the decline in enforcement actions, such as audits, is complicated, and the real impact on taxpayers' rate of voluntary compliance is not known. This leaves open the question of whether the declines in IRS's enforcement programs are eroding taxpayers' incentives to voluntarily comply. IRS's National Research Program (NRP) recently completed a study on compliance by individual tax filers based on tax data provided on 2001 tax returns. The study estimated that the tax gap—the difference between what taxpayers owe and what they pay—is at least \$312 billion per year as of 2001 and could be as large as \$353 billion. This study is important for several reasons beyond measuring compliance. It is intended to help IRS better target its enforcement actions, such as audits, on non-compliant taxpayers, and minimize audits of compliant taxpayers. It should also help IRS better understand the impact of taxpayer service on compliance.

IRS Is Developing Long-term Goals That Can Be Used to Assess Performance and Make Budget Decisions

IRS is developing but currently lacks long-term goals that can be used to assess performance and make budget decisions.⁹ Long-term goals and results measurement are a component of the statutory strategic planning and management framework that the Congress adopted in the Government Performance and Results Act of 1993.¹⁰ As a part of this comprehensive framework, long-term goals that are linked

⁹ IRS has one long-term goal set by the Congress in RRA 98 for IRS to have 80 percent of all individual income tax returns filed electronically.

¹⁰ Public Law No. 103-62 (1993). The Government Performance and Results Act of 1993 seeks to improve the management of Federal programs, as well as their effectiveness and efficiency, by requiring executive agencies to prepare multiyear strategic plans, annual performance plans, and annual performance reports. Under the Act, strategic plans are the starting point for setting goals and measuring progress towards them. The Act requires executive agencies to develop strategic plans that include an agency's mission statement, long-term general goals, and the strategies that the agency will use to achieve these goals. The plans should also explain the key external factors that could significantly affect achievement of these goals, and describe how long-term goals will be related to annual performance goals.

to annual performance measures can help guide agencies when considering organizational changes and making resource decisions.

A recent Program Assessment Rating Tool (PART) review conducted by OMB reported that IRS lacks long-term goals.¹¹ As a result, IRS has been working to identify and establish long-term goals for all aspects of its operations for over a year. IRS officials said these goals will be finalized and provided publicly as an update to the agency's strategic plan before May 2005.

For IRS and its stakeholders, such as the Congress, long-term goals can be used to assess performance and progress towards these goals, and determine whether budget decisions contribute to achieving those goals.

Without long-term goals, the Congress and other stakeholders are hampered in evaluating whether IRS is making satisfactory long-term progress. Further, without such goals, the extent to which IRS's 2006 budget request would help IRS achieve its mission over the long-term is unclear.

This Is an Opportune Time to Review IRS's Menu of Taxpayer Services

For at least two reasons, this is an opportune time to review the menu of taxpayer services that IRS provides. First, IRS's budget for taxpayer services was reduced in 2005 and an additional reduction is proposed for 2006. As already discussed, these reductions have forced IRS to propose scaling back some services. Second, as we have reported, IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago and has noticeably improved the quality of telephone services. This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices. Cuts in selected services could be offset by the new and improved services.

Generally, as indicated in the budget, the menu of taxpayer services that IRS provides covers assistance, outreach, and processing. Assistance includes answering taxpayer questions via telephone, correspondence, and face-to-face at its walk-in sites. Outreach includes educational programs and the development of partnerships. Processing includes issuing millions of tax refunds.

When considering program reductions, we support a targeted approach rather than across-the-board cuts.¹² A targeted approach helps reduce the risk that effective programs are reduced or eliminated while ineffective or lower priority programs are maintained.

With the above reasons in mind for reconsidering IRS's menu of services, we have compiled a list of options for targeted reductions in taxpayer service. The options on this list are not recommendations but are intended to contribute to a dialogue about the tradeoffs faced when setting IRS's budget. The options presented meet at least one of the following criteria that we generally use to evaluate programs or budget requests.¹³ These criteria include that the activity:

- duplicates other efforts that may be more effective and/or efficient;
- historically does not meet performance goals or provide intended results as reported by GAO, the Treasury Inspector General for Tax Administration (TIGTA), IRS, or others;
- experiences a continued decrease in demand;
- lacks adequate oversight, implementation and management plans, or structures and systems to be implemented effectively;
- has been the subject of actual or requested funding increases that cannot be adequately justified; or
- has the potential to make an agency more self-sustaining by charging user fees for services provided.

We recognize that the options listed below involve tradeoffs. In each case, some taxpayers would lose a service they use. However, the savings could be used to help maintain the quality of other services. We also want to give IRS credit for identifying savings, including some on this list. The options include:

- closing walk-in sites. Taxpayer demand for walk-in services has continued to decrease and staff answer a more limited number of tax law questions in person than staff answer via telephone.

¹¹The PART was applied during the fiscal year 2004 budget cycle to "programs" selected by OMB. The PART includes general questions in each of four broad topics to which all programs are subjected: (1) program purpose and design; (2) strategic planning; (3) program management; and (4) program results (i.e., whether a program is meeting its long-term and annual goals). OMB also makes an overall assessment on program effectiveness.

¹²GAO, 21st Century Challenges: Reexamining the Base of the Federal Government, GAO-05-325SP (Washington, DC: February 2005).

¹³We selected these criteria from a variety of sources based on generally accepted government auditing standards.

- limiting the type of telephone questions answered by IRS assistors. IRS assistors still answer some refund status questions even though IRS provides automated answers via telephone and its Web site.
- mandating electronic filing for some filers such as paid preparers or businesses. As noted, efficiency gains from electronic filing have enabled IRS to consolidate paper processing operations.
- charging for services. For example, IRS provides paid preparers with information on Federal debts owed by taxpayers seeking refund anticipation loans.

PROGRESS IN BSM IMPLEMENTATION, BUT THE PROGRAM REMAINS HIGH RISK AND
BUDGET REDUCTIONS HAVE RESULTED IN SIGNIFICANT ADJUSTMENTS

Although IRS has implemented important elements of the BSM program, much work remains. In particular, the BSM program remains at high risk and has a long history of significant cost overruns and schedule delays. Furthermore, budget reductions have resulted in significant adjustments to the BSM program, although it is too early to determine their ultimate effect.

IRS Has Made Progress in Implementing BSM, but Much Work Remains

IRS has long relied on obsolete automated systems for key operational and financial management functions, and its attempts to modernize these aging computer systems span several decades. IRS's current modernization program, BSM, is a highly complex, multibillion-dollar program that is the agency's latest attempt to modernize its systems. BSM is critical to supporting IRS's taxpayer service and enforcement goals. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. BSM is important for another reason. It allows IRS to provide the reliable and timely financial management information needed to account for the Nation's largest revenue stream and better enable the agency to justify its resource allocation decisions and congressional budgetary requests.

Since our testimony before this subcommittee on last year's budget request, IRS has deployed initial phases of several modernized systems under its BSM program. The following provides examples of the systems and functionality that IRS implemented in 2004 and the beginning of 2005.

- Modernized e-File (MeF)*.—This project is intended to provide electronic filing for large corporations, small businesses, and tax-exempt organizations. The initial releases of this project were implemented in June and December 2004, and allowed for the electronic filing of forms and schedules for the form 1120 (corporate tax return) and form 990 (tax-exempt organizations' tax return). IRS reported that, during the 2004 filing season, it accepted over 53,000 of these forms and schedules using MeF.
- e-Services*.—This project created a Web portal and provided other electronic services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically. IRS implemented e-Services in May 2004. According to IRS, as of late March 2005, over 84,000 users have registered with this Web portal.
- Customer Account Data Engine (CADE)*.—CADE is intended to replace IRS's antiquated system that contains the agency's repository of taxpayer information and, therefore, is the BSM program's linchpin and highest priority project. In July 2004 and January 2005, IRS implemented the initial releases of CADE, which have been used to process filing year 2004 and 2005 1040EZ returns, respectively, for single taxpayers with refund or even-balance returns. According to IRS, as of March 16, 2005, CADE had processed over 842,000 tax returns so far this filing season.
- Integrated Financial System (IFS)*.—This system replaces aspects of IRS's core financial systems and is ultimately intended to operate as its new accounting system of record. The first release of this system became fully operational in January 2005.

Although IRS is to be applauded for delivering such important functionality, the BSM program is far from complete. Future deliveries of additional functionality of deployed systems and the implementation of other BSM projects are expected to have a significant impact on IRS's taxpayer services and enforcement capability. For example, IRS has projected that CADE will process about 2 million returns in the 2005 filing season. However, the returns being processed in CADE are the most basic and constitute less than 1 percent of the total tax returns expected to be processed during the current filing season. IRS expects the full implementation of CADE to take several more years. Another BSM project—the Filing and Payment Compliance (F&PC) project—is expected to increase (1) IRS's capacity to treat and resolve the backlog of delinquent taxpayer cases, (2) the closure of collection cases by 10

million annually by 2014, and (3) voluntary taxpayer compliance. As part of this project, IRS plans to implement an initial limited private debt collection capability in January 2006, with full implementation of this aspect of the F&PC project to be delivered by January 2008 and additional functionality to follow in later years.

BSM Program Has History of Cost Increases and Schedule Delays and Is High Risk

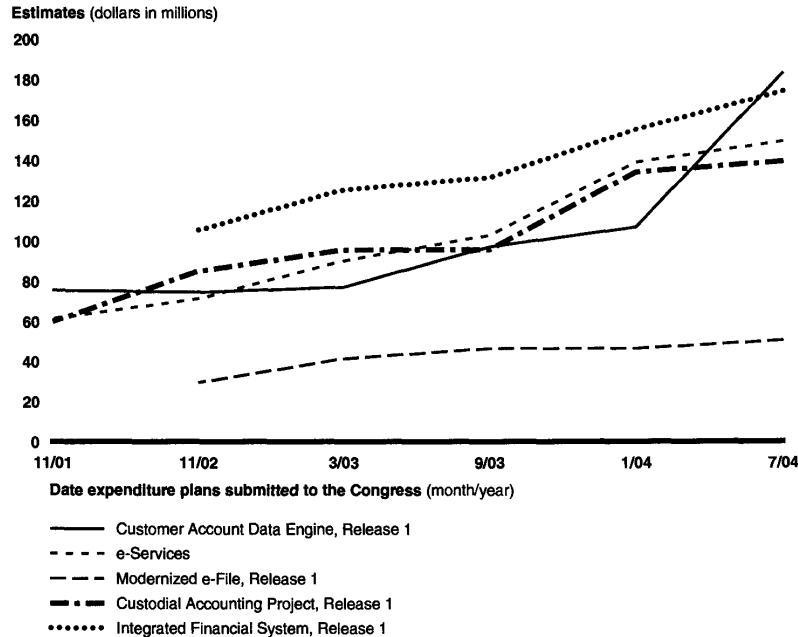
The BSM program has a long history of significant cost increases and schedule delays, which, in part, has led us to report this program as high-risk since 1995.¹⁴ Appendix II provides the history of the BSM life-cycle cost and schedule variances. In January 2005 letters to congressional appropriation committees, IRS stated that it had showed a marked improvement in significantly reducing its cost variances. In particular, IRS claimed that it reduced the variance between estimated and actual costs from 33 percent in fiscal year 2002 to 4 percent in fiscal year 2004. However, we do not agree with the methodology used in the analysis supporting this claim. Specifically, (1) the analysis did not reflect actual costs, instead it reflected changes in cost estimates (i.e., budget allocations) for various BSM projects; (2) IRS aggregated all of the changes in the estimates associated with the major activities for some projects, such as CADE, which masked that monies were shifted from future activities to cover increased costs of current activities; and (3) the calculations were based on a percentage of specific fiscal year appropriations, which does not reflect that these are multiyear projects.

In February 2002 we expressed concern over IRS's cost and schedule estimating and made a recommendation for improvement.¹⁵ IRS and its prime systems integration support (PRIME) contractor have taken action to improve their estimating practices, such as developing a cost and schedule estimation guidebook and developing a risk-adjustment model to include an analysis of uncertainty. These actions may ultimately result in more realistic cost and schedule estimates, but our analysis of IRS's expenditure plans¹⁶ over the last few years shows continued increases in estimated project life-cycle costs (see fig. 3).

¹⁴For our latest high-risk report, please see GAO, High-Risk Series: An Update, GAO-05-207 (Washington, DC, January 2005).

¹⁵GAO, Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload, GAO-02-356 (Washington, DC: Feb. 28, 2002).

¹⁶BSM funds are unavailable until the IRS submits to congressional appropriations committees for approval a modernization expenditure plan that (1) meets the OMB capital planning and investment control review requirements; (2) complies with IRS's enterprise architecture; (3) conforms with IRS's enterprise life-cycle methodology; (4) is approved by IRS, the Department of the Treasury, and OMB; (5) is reviewed by GAO; and (6) complies with acquisition rules, requirements, guidelines, and systems acquisition management practices.

Figure 3: Life-cycle Cost Estimates for Key BSM Projects

Source: GAO analysis of IRS data.

The Associate CIO for BSM stated that he believes that IRS's cost and schedule estimating has improved in the past year. In particular, he pointed out that IRS met its cost and schedule goals for the implementation of the latest release of CADE, which allowed the agency to use this system to process certain 1040EZ forms in the 2005 filing season. It is too early to tell whether this signals a fundamental improvement in IRS's ability to accurately forecast project costs and schedules.

The reasons for IRS's cost increases and schedule delays vary. However, we have previously reported that they are due, in part, to weaknesses in management controls and capabilities. We have previously made recommendations to improve BSM management controls, and IRS has implemented or begun to implement these recommendations. For example, in February 2002, we reported that IRS had not yet defined or implemented an IT human capital strategy, and recommended that IRS develop plans for obtaining, developing, and retaining requisite human capital resources.¹⁷ In September 2003, TIGTA reported that IRS had made significant progress in developing a human capital strategy but that it needed further development. In August 2004, the current Associate CIO for BSM identified the completion of a human capital strategy as a high priority. Among the activities that IRS is implementing are prioritizing its BSM staffing needs and developing a recruiting plan. IRS has also identified, and is addressing, other major management challenges in areas such as requirements, contract, and program management. For example, poorly defined requirements have been among the significant weaknesses that have been identified as contributing to project cost overruns and schedule delays. As part of addressing this problem, in March 2005, the IRS BSM office established a requirements management office, although a leader has not yet been hired.

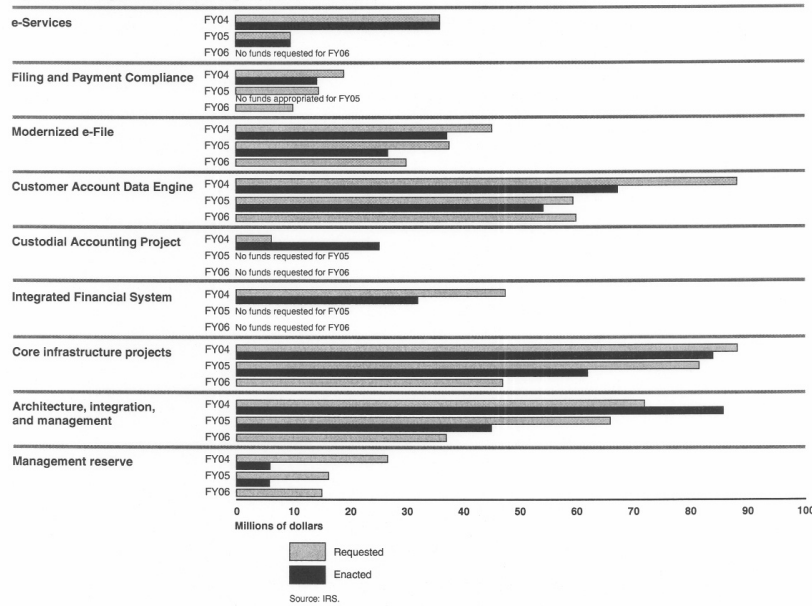
IRS Is Adjusting the BSM Program in Response to Budget Reductions

The BSM program is undergoing significant changes as it adjusts to reductions in its budget. Figure 4 illustrates the BSM program's requested and enacted budg-

¹⁷ GAO-02-356.

ets for fiscal years 2004 through 2006.¹⁸ For fiscal year 2005, IRS received about 29 percent less funding than it requested (from \$285 million to \$203.4 million). According to the Senate report for the fiscal year 2005 Transportation, Treasury, and General Government appropriations bill, in making its recommendation to reduce BSM funding, the Senate Appropriations Committee was concerned about the program's cost overruns and schedule delays. In addition, the committee emphasized that in providing fewer funds, it wanted IRS to focus on its highest priority projects, particularly CADE.¹⁹ In addition, IRS's fiscal year 2006 budget request reflects an additional reduction of about 2 percent, or about \$4.4 million, from the fiscal year 2005 appropriation.

Figure 4: Changes in the BSM budget (dollars in millions)^a



^aThe BSM account authorizes funds to be obligated for 3 years.

It is too early to tell what effect the budget reductions will ultimately have on the BSM program. However, the significant adjustments that IRS is making to the program to address these reductions are not without risk, could potentially impact future budget requests, and will delay the implementation of certain functionality that was intended to provide benefit to IRS operations and the taxpayer. For example:

- Reductions in Management reserve/project risk adjustments.*—In response to the fiscal year 2005 budget reduction, IRS reduced the amount that it had allotted to program management reserve and project risk adjustments by about 62 percent (from about \$49.1 million to about \$18.6 million).²⁰ If BSM projects have future cost overruns that cannot be covered by the depleted reserve, this reduction could result in (1) increased budget requests in future years or (2) delays in planned future activities (e.g., delays in delivering promised functionality) to use those allocated funds to cover the overruns.
- Shifts of BSM management responsibility from the PRIME contractor to IRS.*—Due to budget reductions and IRS's assessment of the PRIME contractor's performance, IRS decided to shift significant BSM responsibilities for program management, systems engineering, and business integration from the PRIME

¹⁸ IRS uses the appropriated funds to cover contractor costs related to the BSM program. IRS funds internal costs for managing BSM with another appropriation. These costs are not tracked separately for BSM-related activities.

¹⁹ U.S. Senate, Senate Report 108-342 (2004).

²⁰ We did not include in our calculations, reductions to specific project risk adjustment amounts that were made for reasons other than the fiscal year 2005 budget reduction.

contractor to IRS staff. For example, IRS staff are assuming responsibility for cost and schedule estimation and measurement, risk management, integration test and deployment, and transition management. There are risks associated with this decision. To successfully accomplish this transfer, IRS must have the management capability to perform this role. Although the BSM program office has been attempting to improve this capability through, for example, implementation of a new governance structure and hiring staff with specific technical and management expertise, IRS has had significant problems in the past managing this and other large development projects, and acknowledges that it has major challenges to overcome in this area.

—*Suspension of the Custodial Accounting Project (CAP).*—Although the initial release of CAP went into production in September 2004, IRS has decided not to use this system and to stop work on planned improvements due to budget constraints. According to IRS, it made this decision after it evaluated the business benefits and costs to develop and maintain CAP versus the benefits expected to be provided by other projects, such as CADE. Among the functionality that the initial releases of CAP were expected to provide were (1) critical control and reporting capabilities mandated by federal financial management laws; (2) a traceable audit trail to support financial reporting; and (3) a subsidiary ledger to accurately and promptly identify, classify, track, and report custodial revenue transactions and unpaid assessments. With the suspension of CAP, it is now unclear how IRS plans to replace the functionality this system was expected to provide, which was intended to allow the agency to make meaningful progress toward addressing long-standing financial management weaknesses. IRS is currently evaluating alternative approaches to addressing these weaknesses.

—*Reductions in planned functionality.*—According to IRS, the fiscal year 2006 funding reduction will result in delays in planned functionality for some of its BSM projects. For example, IRS no longer plans to include Form 1041 (the income tax return for estates and trusts) in the fourth release of Modernized e-File, which is expected to be implemented in fiscal year 2007.

The BSM program is based on visions and strategies developed in 2000 and 2001. The age of these plans, in conjunction with the significant delays already experienced by the program and the substantive changes brought on by budget reductions, indicate that it is time for IRS to revisit its long-term goals, strategy, and plans for BSM. Such an assessment would include an evaluation of when significant future BSM functionality would be delivered. IRS's Associate CIO for BSM has recognized that it is time to recast the agency's BSM strategy because of changes that have occurred subsequent to the development of the program's initial plans. According to this official, IRS is redefining and refocusing the BSM program, and he expects this effort to be completed by the end of this fiscal year.

ADDITIONAL ACTIONS NEEDED TO IMPROVE BUDGETING FOR IT OPERATIONS AND MAINTENANCE

IRS has requested about \$1.62 billion for IT operations and maintenance in fiscal year 2006, within its proposed new Tax Administration and Operations account. Under the prior years' budget structure, these funds were included in a separate account, for which IRS received an appropriation of about \$1.59 billion in fiscal year 2005. The \$1.62 billion requested in fiscal year 2006 is intended to fund the personnel costs for IT staff (including staff supporting the BSM program) and activities such as IT security, enterprise networks, and the operations and maintenance costs of its current systems. We have previously expressed concern that IRS does not employ best practices in the development of its IT operations and maintenance budget request.²¹ Although IRS has made progress in addressing our concern, more work remains.

The Paperwork Reduction Act (PRA) of 1995²² requires Federal agencies to be accountable for their IT investments and responsible for maximizing the value and managing the risks of their major information systems initiatives. The Clinger-Cohen Act of 1996²³ establishes a more definitive framework for implementing the PRA's requirements for IT investment management. It requires Federal agencies to focus more on the results they have achieved and introduces more rigor and structure into how agencies are to select and manage IT projects. In addition, leading private- and public-sector organizations have taken a project- or system-centric ap-

²¹ GAO, Internal Revenue Service: Improving Adequacy of Information Systems Budget Justification, GAO-02-704 (Washington, DC, June 28, 2002).

²² Public Law No. 104-13 (1995).

²³ Public Law No. 104-106 section 5001 et. seq. (1996).

proach to managing not only new investments but also operations and maintenance of existing systems. As such, these organizations:

- identify operations and maintenance projects and systems for inclusion in budget requests;
- assess these projects or systems on the basis of expected costs, benefits, and risks to the organization;
- analyze these projects as a portfolio of competing funding options; and
- use this information to develop and support budget requests.

This focus on projects, their outcomes, and risks as the basic elements of analysis and decision making is incorporated in the IT investment management approach that is recommended by OMB and GAO. By using these proven investment management approaches for budget formulation, agencies have a systematic method, on the basis of risk and return on investment, to justify what are typically substantial information systems operations and maintenance budget requests.

In our assessment of IRS's fiscal year 2003 budget request, we reported that the agency did not develop its information systems operations and maintenance request in accordance with the investment management approach used by leading organizations. We recommended that IRS prepare its future budget requests in accordance with these best practices.²⁴ To address our recommendation, IRS agreed to take a variety of actions, which it has made progress in implementing. For example, IRS stated that it planned to develop an activity-based cost model to plan, project, and report costs for business tasks/activities funded by the information systems budget. The recent release of IFS included an activity-based cost module, but IRS does not currently have historical cost data to populate this module. According to officials in the Office of the Chief Financial Officer, IRS is in the process of accumulating these data. These officials stated that IRS needs 3 years of actual costs to have the historical data that would provide a basis for future budget estimates. Accordingly, these officials expected that IRS would begin using the IFS activity-based cost module in formulating the fiscal year 2008 budget request and would have the requisite 3 years' of historical data in time to develop the fiscal year 2010 budget request. In addition, IRS planned to develop a capital planning guide to implement processes for capital planning and investment control, budget formulation and execution, business case development, and project prioritization. IRS has developed a draft guide, which is currently under review by IRS executives, and IRS expects it to become policy on October 1, 2005. Although progress has been made in implementing best practices in the development of the IT operations and maintenance budget, until these actions are completely implemented IRS will not be able to ensure that its request is adequately supported.

CONCLUSIONS

As IRS shifts its priorities to enforcement and faces tight budgets for service, the agency will be challenged to maintain the gains it has made in taxpayer service. In order to avoid a "swinging pendulum," where enforcement gains are achieved at the cost of taxpayer service and vice versa, IRS and the Congress would benefit from a set of agreed-upon long-term goals. Long-term goals would provide a framework for assessing budgetary tradeoffs between taxpayer service and enforcement and whether IRS is making satisfactory progress towards achieving those goals. Similarly, long-term goals could help identify priorities within the taxpayer service and enforcement functions. For example, if the budget for taxpayer service were to be cut and efficiency gains did not offset the cut, long-term goals could help guide decisions about whether to make service cuts across the board or target selected services. To its credit, IRS has been developing a set of long-term goals, so we are not making a recommendation on goals. However, we want to underscore the importance of making the goals public in a timely fashion, as IRS has planned. The Congress would then have an opportunity to review the goals and start using them as a tool for holding IRS accountable for performance.

In addition, the Congress would benefit from more information about the short-term impacts of the 2006 budget request on taxpayers. The 2006 budget request cites a need for reducing the hours of telephone service and scaling back walk-in assistance but provides little additional detail. Without more detail about how taxpayers will be affected, it is difficult to assess whether the 2006 proposed budget would allow IRS to achieve its stated intent of both maintaining a high level of taxpayer service and increasing enforcement.

BSM and related initiatives such as electronic filing hold the promise of delivering further efficiency gains that could offset the need for larger budget increases to fund

²⁴ GAO-02-704.

taxpayer service and enforcement. Today, taxpayers have seen payoffs from BSM; however, the program is still high risk and budget reductions have caused substantive program changes. IRS has recognized it is time to revisit its long-term BSM strategy and is currently refocusing the program. As we did with long-term goals above, we want to underscore the importance of timely completion of the revision of the BSM strategy.

RECOMMENDATION

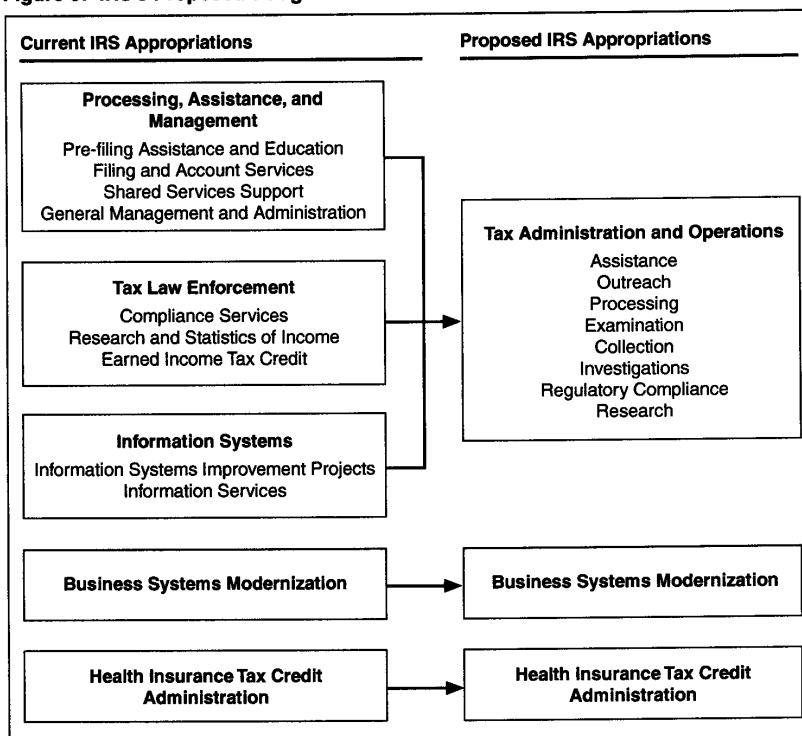
In a related statement (GAO-05-416T), GAO recommended that the Commissioner of Internal Revenue supplement the 2006 budget request with more detailed information on how proposed service reductions would impact taxpayers.

APPENDIX I.—DESCRIPTION OF IRS'S PROPOSED BUDGET STRUCTURE

IRS's proposed new budget structure as depicted in figure 5 combines the three major appropriations that the agency has had in the past—Processing, Assistance, and Management; Tax Law Enforcement; and Information Systems into one appropriation called Tax Administration and Operations. The Business Systems Modernization and Health Insurance Tax Credit Administration appropriations accounts remain unchanged. The Tax Administration and Operations appropriation is divided among eight critical program areas. These budget activities focus on Assistance, Outreach, Processing, Examination, Collection, Investigations, Regulatory Compliance, and Research. According to IRS, as it continues to move forward with developing and implementing this new structure, these program areas and the associated resource distributions will be refined to provide more accurate costing.

IRS reported that the new budget structure has a more direct relationship to its major program areas and strategic plan. We did not evaluate IRS's proposed budget structure as part of this engagement because it was not within the scope of our review. However, we have recently completed a study on the administration's broader budget restructuring effort. In that study we say that, going forward, infusing a performance perspective into budget decisions may only be achieved when the underlying information becomes more credible and used by all major decision makers. Thus, the Congress must be considered a partner. In due course, once the goals and underlying data become more compelling and used by the Congress, budget restructuring may become a better tool to advance budget and performance integration.²⁵

²⁵For a more detailed discussion, see GAO, Performance Budgeting: Efforts to Restructure Budgets to Better Align Resources with Performance, GAO-05-117SP (Washington, DC: February 2005).

Figure 5: IRS's Proposed Budget Structure

Source: GAO representation of IRS information.

APPENDIX II.—BSM PROJECT LIFE CYCLE COST/SCHEDULE VARIANCE AND BENEFITS SUMMARY

The table below shows the life-cycle variance in cost and schedule estimates for completed and ongoing Business Systems Modernization (BSM) projects, based on data contained in IRS's expenditure plans. These variances are based on a comparison of IRS's initial and revised (as of July 2004) cost and schedule estimates to complete initial operation²⁶ or full deployment²⁷ of the projects.

²⁶ Initial operation refers to the point at which a project is authorized to begin enterprise-wide deployment.

²⁷ Full deployment refers to the point at which enterprise-wide deployment has been completed and a project is transitioned to operations and support.

TABLE 4.—BSM PROJECT LIFE CYCLE COST/SCHEDULE VARIANCE AND BENEFITS SUMMARY
[Dollars in thousands]

Project	Cost Variance	Reported/Revised Estimated Cost	Schedule Variance (in Months)	Reported/Revised Estimated Completion Date	Reported IRS/Taxpayer Benefits
Completed projects:					
Security and Technology Infrastructure Release 1	+ \$8,450	\$45,401	+ 5	1/31/02 (initial operation) ¹	Provides infrastructure for secure telephony and electronic interaction among IRS employees, tax practitioners, and taxpayers.
Customer Communications 2001	+ \$14,562	\$60,762	+ 9	2/26/02 (full deployment)	Improves telecommunications infrastructure, including telephone call management, call routing, and customer self-service applications.
Customer Relationship Management Exam	— \$721	\$9,245	+ 3	9/30/02 (full deployment)	Provides commercial, off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions.
Human Resources Connect Release 1	+ \$200	\$10,200	.....	12/31/02 (initial operation) ¹	Allows IRS employees to access and manage their human resources information online.
Internet Refund/Fact of Filing	+ \$12,923	\$26,432	+ 14	9/26/03 (full deployment)	Provides instant refund status information and instructions for resolving refund problems to taxpayers with Internet access.
Modernized e-File Release 1	+ \$21,057	\$50,303	+ 6.5	5/31/04 (initial operation) ¹	Provides initial electronic filing capability for large corporations, small business, and tax-exempt organizations.
Ongoing projects:					
Modernized e-File Release 2 .....	.....	\$16,325	.....	9/30/04 (initial operation)	Provides additional functionality to support corporate electronic filing and other capabilities, including required public access to filed returns for tax-exempt organizations.
Modernized e-File Release 3	+ \$5,300	\$27,175	.....	3/31/05 (initial operation)	Provides additional functionality to support electronic filing for tax-exempt organizations and other capabilities, including the interface with state retrieval systems.
e-Services	+ \$102,271	\$148,820	+ 18	4/30/05 (full deployment)	Provides a Web portal and other e-Services to promote the goal of conducting most IRS transactions with taxpayers and tax practitioners electronically.
Customer Account Data Engine—Individual Master File Release 1.	+ \$118,129	\$182,774	+ 30	6/30/05 (full deployment)	Provides the modernized database foundation to replace the existing individual master file processing systems. Facilitates faster refund processing and more timely response to taxpayer inquiries for Form 1040EZ filers.

TABLE 4.—BSM PROJECT LIFE CYCLE COST/SCHEDULE VARIANCE AND BENEFITS SUMMARY—Continued

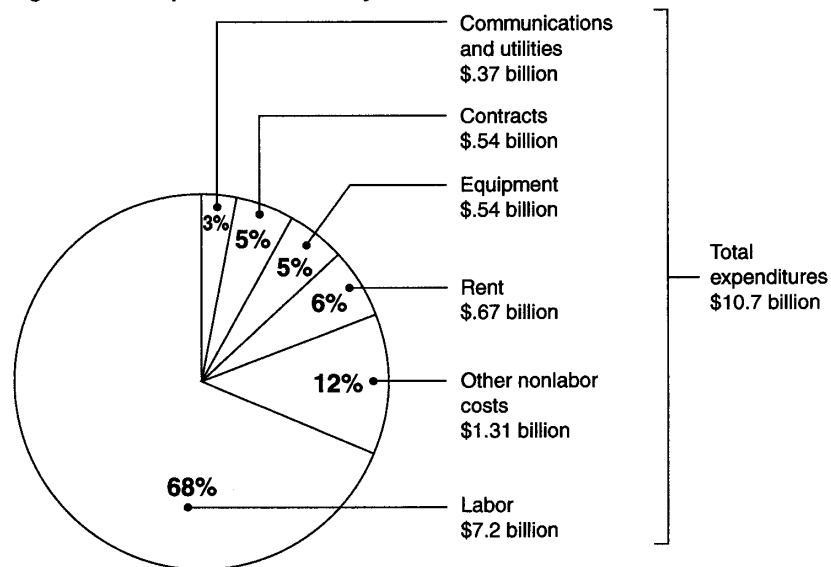
[Dollars in thousands]

Project	Cost Variance	Reported/Revised Estimated Cost	Schedule Variance (in Months)	Reported/Revised Estimated Completion Date	Reported IRS/Taxpayer Benefits
Integrated Financial System Release 1	+ \$73,710	\$173,580	+ 15	6/30/05 (full deployment)	Provides a single general ledger for custodial and financial data and a platform to integrate core financial data with budget, performance, and cost-accounting data.
Custodial Accounting Project Release 1	+ \$91,789	\$138,950	+ 33	11/01/05 (full deployment)	Provides integrated tax operations and internal management information to support evolving decision analytics, performance measurement, and management information needs.

¹ Information on the costs and schedule for the full-deployment stage of these projects was not available in the BSM expenditure plans.
Source.—GAO analysis of IRS data.

APPENDIX III.—HOW IRS ALLOCATED EXPENDITURES FTEs IN FISCAL YEAR 2004

Figures 6 and 7 illustrate how the Internal Revenue Service (IRS) allocated expenditures and full-time equivalents (FTEs) in fiscal year 2004. Figure 8 shows total expenditures. The percentage of expenditures devoted to contracts decreased from 9 percent in 2002 to 5 percent in 2004, because of fewer private contracts. The percentage of expenditures devoted to other non-labor costs increased from 8 percent in 2002 to 12 percent in 2004, according to IRS officials, due to increases in miscellaneous costs.

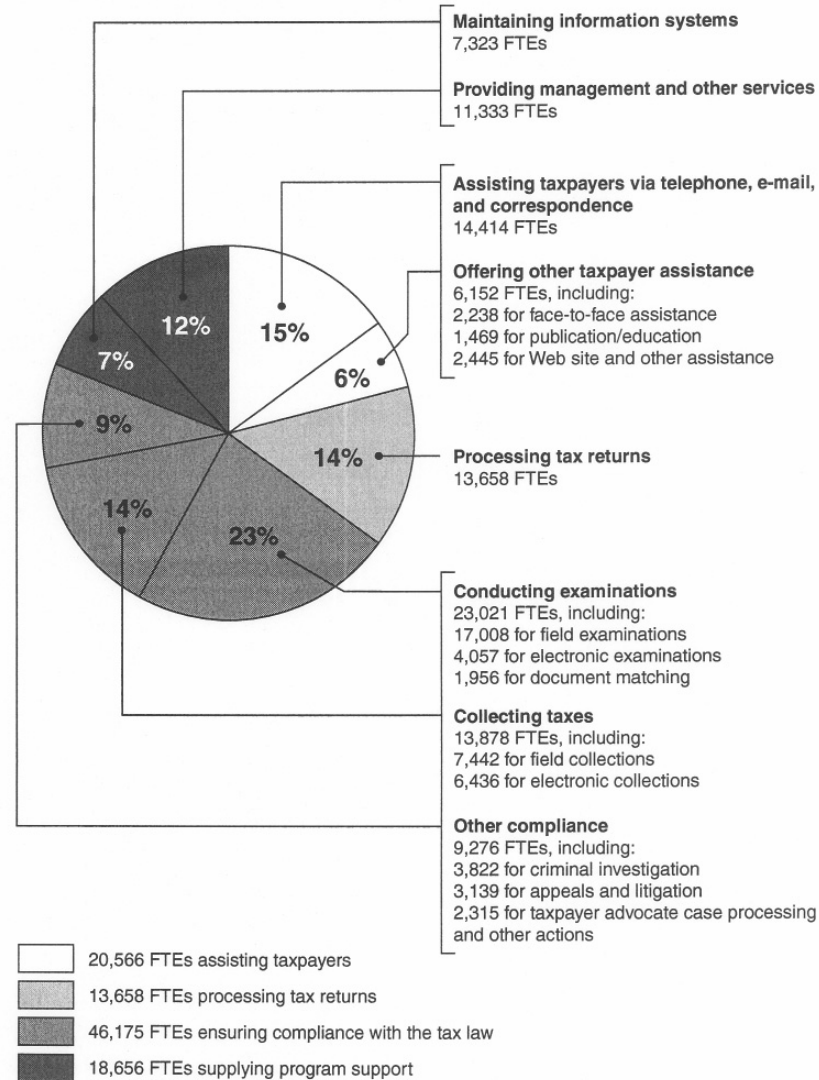
Figure 6: IRS expenditures in fiscal year 2004

Source: GAO analysis of IRS data.

Note: Numbers do not add to the total and percentages do not add to 100 percent due to rounding.

Figure 7 shows IRS's total FTEs. Since 2002, FTEs have decreased slightly from 99,180 in 2002 to 99,055 in 2004. We previously reported that processing FTEs declined 1 percentage point between 2002 and 2003. Between 2003 and 2004, IRS's allocation of FTEs remained similar but with a 1 percent increase in enforcement activities in conducting examinations, and in management and other services.

Figure 7: How IRS spent 99,055 FTEs in fiscal year 2004



Source: GAO analysis of IRS data.

PREPARED STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE

Mr. Chairman and distinguished members of the subcommittee, thank you for inviting me to submit a statement in connection with your hearing on the proposed budget of the Internal Revenue Service for fiscal year 2006.

The IRS is at a critical juncture in its history. In the 6+ years since the enactment of the Internal Revenue Service Restructuring and Reform Act of 1998, the IRS has successfully incorporated valuable customer service practices into its daily

activities at all levels of the organization. It is now trying to increase its enforcement activity without eroding these taxpayer service gains. I strongly support a robust and research-driven IRS that undertakes well-designed examination and collection activities and criminal investigations. I believe that the IRS is capable of conducting these activities in an environment of superior taxpayer service. Given the size of the tax gap, I believe that the IRS needs additional resources to apply to both of these areas.

I also support increased funding for IRS Business Systems Modernization, providing the funds are spent wisely. Systems modernization is a critical component not only for the examination and collection aspects of IRS work but also for the taxpayer service component. Without sufficient funding, we are left continually apologizing to taxpayers because our systems aren't functioning; we create work for ourselves, fixing errors manually because systems create taxpayer problems rather than avoid them.

The role of taxpayer service in an environment of increasing enforcement activity is of great import to taxpayers, tax administrators, and Congress alike. I identified several areas of concern for taxpayer service in my 2004 Annual Report to Congress. Before I discuss some of these issues, I will comment generally about the balance between taxpayer service and enforcement.

THE COMPLIANCE EQUATION

In the IRS Strategic Plan for 2005–2009 and elsewhere, the IRS has emphasized that its guiding principle is “Service + Enforcement = Compliance.” The proposed IRS budget for fiscal year 2006 would revamp existing budget categories to fit this guiding principle, placing 33 percent of the IRS budget into a “taxpayer service” account and 65 percent of the IRS budget into an “enforcement” account. (The remaining 2 percent of the proposed budget is allocated to Business Systems Modernization and Health Insurance Tax Credit Administration.)

At a conceptual level, the “Service + Enforcement = Compliance” principle is indisputably correct. Compliance represents the sum total of IRS's success in helping taxpayers file tax returns and pay tax, and IRS's success at enforcing the law when taxpayers fail to do what is required. What is less clear is the appropriate balance between service and enforcement, particularly in a resource-constrained budget environment. “Service + Enforcement = Compliance” does not in and of itself define a specific level of compliance. That is, each of the equation's elements is a variable. Thus, if we reduce service, there is no guarantee—no matter how much we increase our enforcement efforts—that compliance will increase overall. It is entirely possible that an increase in enforcement initiatives, offset by a decrease in taxpayer service, would result in less compliance.

How can that be? The answer is that our estimated 84 percent voluntary compliance rate is driven primarily by the fact that most income is subject to income and payroll tax withholding or to third-party income reporting. If we do not provide adequate taxpayer service to these taxpayers and their employers or payors—who are either compliant or trying to be compliant—then compliance by these taxpayers will decline. The IRS would then be forced to divert its enforcement resources, in part, to address this new source of noncompliance.

Last week, the IRS released a preliminary estimate of the tax gap based on the recent National Research Program study. This study estimates the net tax gap (i.e., the gross gap reduced by late payments and enforced payments) in the range of \$257–\$298 billion annually and a voluntary compliance rate of approximately 84 percent. That rate is generally consistent with the results of prior studies.

Today, there are approximately 130 million individual taxpayers. Each individual taxpayer is paying, on average, a “surtax” of at least \$2,000 a year to subsidize noncompliance. That's the bad news. The “good” news, if you can call it that, is that notwithstanding claims that the decline in IRS enforcement activity in the aftermath of the IRS Restructuring and Reform Act of 1998 led to rampant cheating, the estimate of the compliance rate in the recent tax gap study is approximately the same as the compliance rate when the prior study was conducted in the late 1980's.

Even so, a principal function of the IRS is to collect all tax due, so the big question is what do we do now to increase the compliance rate? The proposed IRS budget reflects the view that enforcement activity should be increased while taxpayer service is reduced. Is that the right answer?

If I were developing a budget from scratch, I would argue that both enforcement and taxpayer service funding should be increased. The IRS is the accounts receivable department of the Federal Government, and it is clear to me that additional funding for both enforcement and taxpayer service—if spent wisely—would bring in significantly more dollars.

Given the budget realities, however, I am concerned that the IRS does not have better research to show where its dollars could be most effectively spent. Indeed, the one function I am certain requires more resources is the IRS research function. The IRS is able to track revenue collected as a direct result of its enforcement activities. While that is useful information, it is the indirect effects of IRS activities—on both the taxpayer service side and the enforcement side—that generate a far greater amount of revenue. Even if the IRS only audits about 1 percent of tax returns, for example, much larger numbers of taxpayers will choose to comply because of the possibility that they could be audited. Thus, a single audit has a “ripple” effect or, in economic terms, a “multiplier” effect.

Not all audits are created equal, however: \$1 spent on auditing industries with historically high rates of noncompliance, such as the construction industry, may have a very different multiplier than an audit of a corporate tax shelter. Similarly, \$1 spent on making it easier for taxpayers to comply with their tax obligations—e.g., publishing forms, advertising e-file, answering tax law questions—almost certainly has a multiplier effect as well. We simply don’t have adequate research to show where the next dollar is best spent.

Moreover, in terms of improving overall tax compliance, we don’t have data that show whether the “multiplier effect” is generally greater at this time for enforcement or for taxpayer service. Thus, a decision to increase enforcement and reduce taxpayer service is, to a large degree, based more on instinct than solid research. To be sure, this is not easy research to do, and in any event, it is a long-term project that will not assist in fiscal year 2006 budget decisions. But in the absence of better research, it is important to emphasize that the decision about how much to increase or decrease certain activities represents merely a policy call based on educated guessing.

If the proposed budget categories are enacted, we still face the challenge of allocating IRS costs among them. Many, if not most, IRS expenses cannot be unambiguously placed under either the “enforcement” or the “taxpayer service” umbrella. For example, the proposed budget lists the \$1.3 billion cost of submission processing as a “taxpayer service.” In reality, I view this cost more as a core business function. Processing tax returns provides service to the extent that it is necessary to enable the IRS to issue tax refunds. On the other hand, return processing is central to the IRS’s ability to classify returns for audits and determine balances due on returns.

The proposed division of the budget into two categories has also triggered internal budget competition. Since the overall budget proposes to increase the enforcement category by 8 percent and reduce the taxpayer service category by 1 percent, operating divisions and functions clearly benefit from placing as much of their programming as possible into the enforcement category. Although final decisions have not been made, this budget approach seems to be leading to some questionable results.

For example, we have been told that more than 90 percent of the funding for the Office of Appeals and the Office of Chief Counsel will be allocated to enforcement. By contrast, we have been told that none of the funding for the Taxpayer Advocate Service (TAS) will be allocated to enforcement—indeed, that TAS will be the only function in the IRS allocated entirely to taxpayer service. Considering that 85 percent of TAS’s funding is currently allocated to the Tax Law Enforcement (TLE) account and that fully two-thirds of TAS’s cases are enforcement-related (i.e., cases where taxpayers seek help from TAS due to actual or perceived mistakes made by IRS examination or collection personnel), there is little principled basis for this difference in treatment. The practical effect of allocating TAS entirely to taxpayer service is that it increases the likelihood that the TAS budget will sustain significant cuts.

Among the many measures the IRS is considering to reduce taxpayer service costs, I discuss my concerns about two below.

ELECTRONIC TAX LAW ASSISTANCE (ETLA)

Electronic Tax Law Assistance (ETLA) is a service provided through a link on the official IRS website that allows taxpayers or practitioners to send tax law questions electronically to the IRS. The system is designed to allow employees to pull responses from the database of pre-written answers and thus save time researching and responding to frequently asked questions. As originally conceived, ETLA was the first stage in a multi-level approach to tax law assistance, using artificial intelligence technology to recognize and answer the easiest questions and reserving valuable IRS employees for the more complex questions. In a recent customer survey, over 90 percent of taxpayers using ETLA stated that they would use the service again.

We understand that the IRS is considering a proposal to discontinue providing tax law assistance over the Internet. I think this would be a mistake. The benefits of providing answers to taxpayer questions by Internet are significant. Most taxpayers now have Internet access, and many taxpayers prefer to write up their questions precisely and submit them electronically to avoid waiting on hold to speak with telephone assisters. In fact, in other areas of tax administration, the IRS is justifying the reduction of face-to-face service due to the availability of Internet applications. Although Internet-based assistance should not be the sole or even primary means of providing tax law assistance, ETLA is still very useful, and I understand the savings from eliminating it would be only about \$1.5 million.

TAXPAYER ASSISTANCE CENTERS (TACS)

The IRS is planning to close a significant number of its approximately 400 walk-in sites (also called "Taxpayer Assistance Centers" or "TACs"). Here, the estimated savings are larger—approximately \$50 million. To date, the IRS has not identified alternative means to assist taxpayers who require face-to-face assistance. This is unfortunate since taxpayers will continue to seek the assistance they require. The Taxpayer Advocate Service and other IRS offices co-located with TACs subject to closure are particularly likely to see an upsurge in taxpayer requests for assistance.

In a tax system with 130 million individual taxpayers, there is no one-size-fits-all solution to any problem. Some taxpayers strongly prefer—or, depending on personal limitations, may even require—face-to-face contacts, some need telephone contacts, and some prefer to interact with the IRS electronically. A significant study released last year by the Pew Internet and American Life Project examined how Americans communicate with the government. Generally, the study found that most Americans prefer to communicate with the government orally (either by phone or in person), rather than by letter or over the Internet. Notably, fully 20 percent of Americans reported that their most recent contact with the government was in person. In a few States, the IRS has experimented with using mobile vans to cover a greater number of areas. For example, the van might move weekly among five locations in a State. It could show up at a local library in a town every Monday, for example, and visit other cities on other days of the week. A mobile van would not be as convenient as having a fully staffed office that is open daily, but if the IRS is planning to close a significant number of offices, it should at a minimum consider whether an approach like this might allow the IRS to remain accessible at a much lower cost.

The IRS has developed a model incorporating many factors to help it determine which TACs to close. I applaud the serious effort that went into creating this model over a very short period of time—a matter of months. Built using demographic and other taxpayer data, the model provides an excellent first stage for an analysis of TAC closures. In my view, however, the IRS should supplement this model with a comprehensive survey of taxpayers' need for face-to-face service. The model's reliance on TAC usage over the last few years, as a proxy for taxpayer need, is inadequate since the IRS has reduced the services provided in TACs over that period due to resource concerns.

The speed with which the IRS is making decisions of such momentous import to taxpayer service, and the lack of stakeholder engagement, is of great concern to me. I was briefed on this model on March 22 of this year, too late to have any but the most trivial influence on its development. It is my understanding that the IRS consulted the Internal Revenue Service Advisory Committee (IRSAC) with respect to the weighting of factors used to determine closings. However, the IRS did not consult the Taxpayer Advocacy Panel (TAP), a Treasury panel of volunteer taxpayers specifically chartered under the Federal Advisory Committee Act to advise the IRS on matters pertaining to customer service. Nor did the IRS seek comments or suggestions from the Low Income Taxpayer Clinics funded by the IRS under IRC § 7526, which presumably represent the interests of a portion of the taxpayer population affected by these closings.

In light of the lack of any taxpayer-centric assessment of the need for face-to-face service, or any accurate measure of the impact of TAC closings on compliance, or any significant engagement with stakeholders, or any identification of alternative methods for providing face-to-face service, I believe that closing Taxpayer Assistance Centers at this time will irrevocably harm taxpayers.

CONCLUSION

The IRS faces significant challenges in the next few years as it attempts to increase taxpayer compliance. To achieve this goal, the IRS needs to do a better job of identifying and balancing both taxpayer needs and enforcement efforts. Rather

than making resource-driven decisions that are based on inadequate research and that fail to identify equivalent alternatives, the IRS must develop a world-class research function that is the foundation for all of its customer service and enforcement activities. Research—and truly strategic planning—should inform the IRS's allocation of resources so that we achieve the maximum compliance possible by obtaining the optimal balance between service and enforcement.

ADDITIONAL COMMITTEE QUESTIONS

Senator BOND. As I've indicated earlier in my statement, it would help us a lot if we could get some funding credit in the badly out-of-date scoring systems for the money that comes in for the IRS activities that we fund. This would help Congress and the IRS to assist more taxpayers and, more importantly, bring in more revenue.

We will leave the record open until next week for my colleagues to submit questions. And we would appreciate your prompt attention to and response to these. And I thank our witnesses and those who've come to hear us.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR PETE V. DOMENICI

CAPITAL GAINS TAX RATE FOR ART AND COLLECTIBLES AND FUEL TAX FRAUD

Question. Commissioner Everson, I am a long-time advocate of equitable treatment for all capital gains, and I plan to introduce a bill to correct the tax code's disparate treatment of various capital gains to ensure fairness for all types of investors.

My legislation would reduce the capital gains tax rate for sales of art and collectibles to 15 percent—the same rate of taxation for most capital gains relating to stock and bond sales. In addition to being fair to individuals who choose to invest in art or other collectibles, I believe that this legislation would raise revenue for the U.S. Treasury because lowering the capital gains rate would encourage people to buy and sell art and collectibles, which would increase the number of people paying tax on art and collectibles.

Would you anticipate an increase in art and collectibles sales if the capital gains tax rate were lowered for such sales?

Answer. Generally, a reduction in tax may result in an increase in affected sales. However, the Department of the Treasury has not prepared a revenue estimate that would chart the effects of this particular proposal.

Question. Will you provide me with the amount of revenue generated last year by the capital gains tax on the sale of stocks and bonds and the amount of revenue generated last year by the capital gains tax on the sale of art and collectibles?

Answer. For 2002, the most recent year for which tax data are available, total tax revenue on capital gains from stocks, bonds, and other assets subject to preferential capital gains rates was \$49 billion. Separate data are not available for capital gains on sales of artworks and collectibles. This category is likely well below 1 percent of capital gains realizations and revenues, and too small to be measured meaningfully with existing sales of capital assets tax data samples.

Question. What was the administration's reasoning for lowering the capital gains tax rate for some investments, but keeping a higher tax rate for art and collectibles?

Answer. The Taxpayer Relief Act of 1997 generally reduced the maximum rate on adjusted net capital gain of an individual from 28 to 20 percent. Although both the House and Senate versions of the Act generally reduced the maximum capital gains tax rate for individuals, both versions maintained the then-current law maximum 28 percent rate for collectibles such as artwork, rugs, antiques, metals, gems, stamps or coins, and the conference report retained this rule for collectibles. The legislative history of the Act does not give a specific reason for this treatment. The Jobs and Growth Tax Relief Reconciliation Act of 2003 generally reduced the maximum rates on adjusted net capital gain of an individual from 10 and 20 percent to 5 and 15 percent. It did not modify the category of 28 percent rate gain including collectibles.

Question. Has the administration considered expanding the new, lower capital gains tax rate to apply to art and collectibles?

Answer. The administration's Budget does not include any proposed modifications to the taxation of sales or exchanges of collectibles. The President has appointed an Advisory Panel on Federal Tax Reform to consider fundamental changes throughout the tax Code. The Panel's report is due by July 31, 2005.

CAPITAL GAINS TAX RATE FOR ART AND COLLECTIBLES

Question. The legislation I mentioned would also correct the inequity afforded to artists who donate their work to charity. Under current law, if a collector donates a painting to a museum, he or she is entitled to a tax deduction equal to the fair market value of the artwork. However, if the artist who created the work were to donate the same painting, he or she is only entitled to a deduction for the paint, the canvas, and any other art supplies involved in creating the work.

This provision of the Tax Code creates a tremendous disincentive for artists to donate their work and negatively impacts museums, libraries, and schools, which depend on such donations to grow their collections. My legislation would remedy this unfairness by allowing artists to deduct the full market value of artwork they donate.

Would you expect more artists to donate their works to charity if they were subject to the same charitable contribution rules as art collectors?

Answer. Yes. We would anticipate a significant increase. The IRS anticipates a significant increase because the proposal would allow artists to claim a deduction for amounts that are not included in income. Current law does not allow a deduction for the value of donated services. This current-law rule generally produces the same tax results for individuals who assist charities by providing volunteer services as for individuals who make charitable contributions of cash.

Question. Can you tell me how many artists sought deductions for charitable contributions of their art work in 2004?

Answer. This information is not available.

FUEL TAX FRAUD

Question. Commissioner Everson, over the last several months we have been working very hard to identify ways of shoring up the highway trust fund without raising taxes. Recently a lot of attention has focused on the revenue lost to fuel tax fraud, and in this case, the ability of criminals to remove red dye from untaxed diesel fuel using straightforward techniques. I have heard from your office that the IRS is looking at various technologies to address this issue, but it is being held up because there is no field test. It certainly seems we could be simultaneously implementing more effective technology while exploring options for a more effective field test.

Why is a field test critical to the success of this program?

Answer. Each year U.S. consumers buy more than 61 billion gallons of diesel fuel and over 26 billion gallons of aviation grade kerosene. Both of these products can be and are used in highway vehicles. Currently, the IRS uses the red dye field test to monitor compliance with the payment of fuel excise taxes. When the IRS takes a sample of fuel from a motor vehicle, the results are immediate. If the sample does not show any traces of red dye, the IRS releases the vehicle and discards the sample. If the field sample shows traces of red dye, the IRS forwards the sample to its laboratory for a complete analysis, and the Fuel Compliance Officers (FCOs) gather information from the owner of the truck, which the IRS uses to assess a penalty for improper use of dyed fuel. Without such a field detection device, the IRS would have to randomly select fuel from millions of highway vehicles and tens of thousands of retail stations, and gather identifying information from them as well, in order to monitor compliance with the payment of fuel excise taxes. The IRS would have to analyze each sample at a laboratory and then would have to follow up with those individuals or businesses that failed the test.

The principal drawback to the current testing is the inability to determine immediately if the red dye has been removed from red dye diesel fuel. If this removal has been done effectively, there is no visible trace left to detect, and the fuel looks just the same as taxed fuel that has never been dyed. While the IRS agrees some type of invisible marker (such as the recently promoted molecular marker) would enable the IRS to detect dye removal, it would have to send all fuel samples to a lab for analysis to determine the presence of the marker in the fuel. Such an approach is not operationally or economically feasible. Hence, the IRS needs some type of field device by which IRS FCOs can readily detect the existence of a marker. To date, the IRS has not been shown a practical field device.

Question. It certainly appears that the Red Dye has failed as a field test, so why are we allowing perfect to be the enemy of the good and losing hundreds of millions of dollars by not implementing another method to detect fraudulent fuel?

Answer. The IRS does not believe that the red dye field test regime has been a failure. In the vast majority of cases, the red dye provisions have been successful in keeping non-taxable fuel off the highways. Upon its initial implementation, the red dye regime yielded significant tax increases and continues to be an effective deterrent today. It is only recently that the IRS has begun to see products that appear to have had the red dye removed. The extent of the removals is unknown, but the IRS does not believe that it is widespread. The IRS is not aware, nor has it stated, that it is losing hundreds of millions of dollars due to the removal of the red dye. As requested in the Appropriations bill, the IRS is continuing to look at the possibility of using the molecular marking regime and has discussed the potential usage with the American Petroleum Institute (API). They have raised significant issues regarding the blending, product quality, company indemnification and reliability of the sampling. The IRS is continuing to work with the promoter of the field screening device to reach an acceptable field performance level.

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

PRIVATE COLLECTION AGENCIES

Question. In January of 2005, the IRS briefed my staff on the schedule for implementing private debt collection over the next few years, including the number of agencies involved, and how much the IRS plans to spend in fiscal year 2005 and successive years. Please provide a detailed update of this information.

Answer. The IRS has made significant progress toward the initial implementation of the private debt collection initiative. Since the briefing in January 2005, the IRS has developed a release schedule that will provide for limited implementation in January 2006. The IRS will develop additional systemic functionality for January 2007. Full implementation of the private debt collection program is scheduled for January 2008 with enhanced reporting, monitoring and control capabilities. This schedule will allow for a controlled ramp-up of additional volumes of delinquent account placements with private collection agencies.

In March 2005, the IRS selected a software vendor to provide inventory management support of the private debt collection accounts. The vendor is a proven leader in collection inventory management applications with over 19 State deployments of their software. The inventory management vendor is on board and has been working with IRS staff to ensure successful deployment of the supporting software applications in time for placement of delinquent accounts with private collection agencies.

The IRS has prepared the statement of work to secure the services of private collection agencies, and the contracting officer provided it to potential vendors on April 27, 2005. The IRS expects to award contracts in July 2005 with initial account placements in late January 2006. The IRS has identified the initial workload for placement with private collection agencies and anticipates placing approximately 40,000 accounts within the first 9 months of operation.

The IRS has developed support structures and roles and responsibilities. The IRS has identified operational sites and is making progress on securing facilities. The IRS has identified a number of key policy concerns and successfully worked them to resolution. The IRS is drafting internal and external policies and procedures, with anticipated completion scheduled for late summer.

The IRS has developed and approved a project schedule for the limited implementation. The IRS has also developed a project budget and secured funding for the current fiscal year. Additional funding is included in the BSM spend plan requests for fiscal year 2006. The IRS has established a project governance structure and its members meet regularly with the project leadership to review progress against scheduled activities and to provide guidance to the team. With the current strong leadership in place, the IRS anticipates a successful implementation of the private debt collection efforts.

The current information technology projected costs and budget for fiscal year 2005 totals \$15.5 million. This funding amount reflects the full costs of the "limited implementation" for January 2006 of \$9.5 million and an additional \$6 million to begin the activities that support the January 2007 implementation.

BUSINESS SYSTEMS MODERNIZATION

Question. Once finalized, the Custodial Accounting Project is supposed to be a single, integrated data repository of taxpayer account information and accessible for

management analysis and reporting. However, costs for the Custodial Accounting Project have continued to increase, with the cost for the first phase in the neighborhood of \$98 million. But this project is now on hold and may never go forward. What is the latest on this project's cost and do you expect it to ever come to fruition?

Answer. The BSM office designed CAP to provide integrated, reliable tax operations and internal management information to support decision analytics, performance measurement, and management information needs. CAP also provided a data warehouse loaded with detailed taxpayer account and collections information to be used for analysis and financial reporting to oversight organizations. The IRS conceived CAP as a multi-release solution, and BSM delivered the first two releases into production in September 2004 and November 2004. However, for CAP to have sustainable value to the IRS, it required two additional releases—for business master file taxpayers and for collections data. Collectively, these releases would take at least 3 years to complete and cost more than \$100 million. In addition, maintenance and support for fielded CAP releases will cost more than \$10 million annually. Within the current budget context, the IRS evaluated benefits and costs of continued CAP investment against the value to taxpayers and IRS employees, competing priorities such as CADE, MeF, F&PC, and maintaining core infrastructure. The IRS determined in January 2005 continued CAP investment is no longer a viable or sound business decision; however, the IRS will leverage CAP work products and knowledge gained in other BSM initiatives (e.g., BSM will use CAP data models on CADE; the IRS now performs data segmentation and analysis in a more modernized way, etc.). The CFO's office is pursuing a current production environment (CPE) upgrade alternative that meets their needs. There are no plans to revive CAP at this time.

Question. The contractor for Business Systems Modernization developed a system for the IRS known as the Security Audit and Analysis System to gather information for use in audits. Specifically, the system would enable users to detect unauthorized activities and facilitate the reconstruction of events if unauthorized activities occurred. However, problems have prevented users from accessing the data once it has been collected. When the contractor delivered the system to the IRS in 2002, the IRS was aware that the system did not meet IRS requirements but accepted the system with the understanding that it would be fixed. Have these problems with the system been resolved?

Answer. Since the initial delivery of the system in 2002, the IRS has successfully resolved several requirements issues and is pleased the Security Audit and Analysis System (SAAS) is effectively managing audit trail data for modernization systems. Security Managers and Modernization System Managers can generate Modernization Managers Security Reports (MMSR) of employee access to taxpayer data from the SAAS system. The Treasury Inspector General for Tax Administration (TIGTA) should be able to begin their pilot use of SAAS in the summer 2005. The use of the SAAS reports by TIGTA is delayed until they complete the testing of the current system audit trails. Final data updates for this capability are underway and the TIGTA should complete testing in the summer 2005. Activities continue to plan the transition of current production systems audit trail analysis capabilities to the SAAS system for TIGTA use. Mission Assurance and Security Services, TIGTA, Modernization, Information Technology Services (ITS) and the PRIME Contractor are working together to define and prioritize the implementation of additional requirements and enhancements to the SAAS system, which will be implemented in 2005 and 2006.

When IRS fully deploys SAAS, it will process two sources of "audit trail" data. One source is audit trails for modernized systems (e.g. IFS, Modernized E-file, E-services, IRFOF, etc.) and another is audit trail historic data from the legacy Integrated Data Retrieval System (IDRS) and Corporate Files on Line (CFOL) production systems. A current production system called ATLAS, which continues to function while the IRS transitions its capabilities to SAAS, currently captures this legacy system audit trail data and processes it. The TIGTA will continue to utilize ATLAS to review potential Unauthorized Access (UNAX) violations until the IRS fully tests the SAAS system in a production environment using production data. The IRS moved the ATLAS data to SAAS to provide more modern technology support to the TIGTA users, provide a single system for TIGTA to access their data instead of their accessing both ATLAS and SAAS, and to allow the retirement of the ATLAS system. The IRS previously processed and loaded the ATLAS data into a data mart containing 60 months of historic data, but the IRS is currently updating it to contain data from the last 4 months of 2004 audit trail information into SAAS, and then it will load the IDRS/CFOL data from 2005.

Once the IRS loads the remaining 2004 historic IDRS data into SAAS, the IRS needs to complete testing of multi-year report functionality. At that point, TIGTA

will begin to conduct a formal customer acceptance test in the SAAS Production system. After the TIGTA completes the customer acceptance test results, the IRS will make any necessary systems changes and TIGTA will begin a 3-month parallel test of both ATLAS and SAAS in Production prior to making any decisions about retiring the current CPE system. TIGTA may determine that a second 3-month parallel test of both ATLAS and SAAS is required based on the results of the CAT testing and the initial parallel test. The current completion dates are in the SAAS Production schedule (05/31/2005 schedule) as follows:

—*Final Data Checkout on the loading of the 60 months of historic data into the SAAS DataMart.*—7/19/05;

—*Complete initial TIGTA CAT in Production.*—8/22/05.

The IRS is still working with TIGTA to reach agreement on a plan and schedule for conducting the parallel test between SAAS and ATLAS in Production. The IRS based the current schedule, which calls for this test to begin in November 2006, upon the current estimates for loading all historical audit trail data for 2005 into the SAAS data mart. Delays in loading the most current 60 months of historic audit trail data into the SAAS Production system have caused schedule delays, and the IRS is looking at options (e.g., performance enhancements, capacity upgrades) that may accelerate the current schedule estimates. The current projected completion dates in the SAAS Production schedule as of 05/31/2005 are:

—*Final Datamart load of the 2005 data.*—9/12/06;

—*Execute 3 month parallel ATLAS/SAAS Production testing.*—12/08/06;

—*Execute 2nd 3 month parallel testing.*—3/31/07—dependent on TIGTA's satisfaction following the first 3 months parallel testing;

—*Retire ATLAS.*—3/31/07 following 6-month ATLAS/SAAS parallel testing.

TELEFILE—FILING TAX RETURNS BY TELEPHONE

Question. The IRS is reducing submissions processing activities because taxpayers are filing fewer paper returns. In 2004, almost 4 million taxpayers filed by telephone—57 percent of whom had income of \$20,000 or less and 97 percent had income of \$50,000 or less. Additionally, nearly 1 million businesses used the TeleFile technology to file their employment tax forms. The IRS's own survey reveals that nearly 40 percent of the individual Telefilers will go back to paper filing. Further, there is currently no electronic alternative for the businesses that use TeleFile. Nonetheless, the IRS is proposing to eliminate TeleFile because the IRS says use has declined somewhat and it is a bit more expensive to maintain than paper or electronic filing. Why was the decision made to eliminate TeleFile without first providing a viable, easy-to-access means of filing for these individuals and businesses that ensured an electronic filing rather than forcing them back to paper filing? Did the IRS look at ways to achieve efficiencies in the operation of the current TeleFile system? If so, what were they? Were these pursued?

Answer. The TeleFile program has certain requirements, such as telecom, printing and postage cost that cannot be restructured or reduced; therefore, the IRS could not develop efficiencies within the current TeleFile program.

In making the decision to sunset TeleFile, the IRS considered the declining use of TeleFile, the discontinuation of several State TeleFile programs, including California's decision to cease TeleFile in 2005, and the growth of other electronic filing alternatives, such as Free File. In fact, Free File volumes grew from 3.5 million returns in 2004 to 5.0 million returns in 2005, a 46.6 percent increase. At least 60 percent of individual filers qualify for Free File services and all TeleFile-eligible filers with access to the Internet can use Free File. Additionally, in their decision, the IRS considered the June 2004 Electronic Tax Administration Advisory Commission (ETAAC) report recommendation to discontinue TeleFile. By sunseting TeleFile, the IRS will eliminate growing information systems operational costs of \$3 million–\$5 million annually and printing and postage costs of \$4 million–\$5 million annually.

The IRS has not developed a similar alternative for employment tax returns. The same cost and infrastructure issues that the IRS faced with Forms 1040 still persist. However, there are low cost alternatives currently available to electronically file the Form 941.

Telefilers may initially revert to paper filing (37 percent according to a customer satisfaction survey), but research shows they rebound to electronic filing at a higher rate than the general population. Sixty-two percent of Telefilers said they would try another e-file option if TeleFile was no longer available.

TAXPAYER SERVICES

Question. The IRS is reducing its face-to-face service providing taxpayers with information and filing assistance. Instead, the IRS wants to direct taxpayers to the

IRS website and to volunteer tax return preparers. In particular, the IRS plans to decrease the level of pre-filing services offered by Taxpayer Assistance Centers. The problem with this is that some taxpayers rely on the face-to-face service. The IRS notes, in its Strategic Plan, that it must “continue to use a comprehensive range of products and services to reach [their] customers, including those who do not use electronic services.” Mr. Everson, how does the IRS’s plan to reduce face-to-face services adequately provide for these taxpayers who won’t use electronic services?

Answer. In recent years, the IRS has seen a significant shift in the ways Americans interact with the Service. Compared to the past, fewer taxpayers are choosing to write or call the IRS; even fewer taxpayers are using walk-in TACs. Instead, more and more Americans are turning to volunteers for return preparation and they are obtaining forms and tax information from the IRS’s Internet site. In addition, most TAC services are available through the IRS’s Toll-Free telephone system at a greatly reduced cost and with higher quality. In a report issued last year, the Government Accountability Office (GAO) stated, “improvement in phone service, increased web site use and the availability of volunteer sites raises a question about whether the IRS should continue to operate as many walk-in sites.”

In making the business decision regarding the TACs, the IRS considered the long-standing concept of operations for Field Assistance that emphasizes accounts and collection work, with customers who need assistance increasingly served through self-service mechanisms, and reliance on community-based volunteer partners for return preparation assistance. The IRS anticipated that as these partnerships grew and increasingly met the needs of community members, the customer traffic in IRS TACs would be reduced. In making this decision, the IRS also considered changing taxpayer behavior, the availability of new and improved alternative services, and the cost benefits of these alternatives compared to walk-in service.

When taxpayers have tax law questions or questions about their accounts, the IRS’s Toll-Free service will route them to the assistant who has the expertise to answer their particular question. If a taxpayer needs a form, the IRS website has every form available for download, and paper forms are available at 32,000 local libraries, banks, post offices and other outlets. When taxpayers need help preparing their returns, they can visit one of the 14,000 VITA and TCE sites available throughout the country. If a taxpayer still needs face-to-face service with an IRS representative, more than 300 TACs will still be available across the country to provide that service as well.

ACCURACY OF TAX INFORMATION

Question. Mr. Everson, if you succeed in reducing the number of Taxpayer Assistance Centers, it will become even more important that the remaining avenues available to taxpayers seeking information be accurate. Recently, the Treasury Inspector General for Tax Administration (TIGTA) found that taxpayers have alerted the IRS of possible errors on the IRS.gov website but these concerns were not always addressed. TIGTA also found that the IRS could not verify whether correct changes had been made to the website. Mr. Everson, if compliance is an utmost priority to the IRS, how can you expect taxpayers to comply if the information they receive from the IRS isn’t accurate or reliable?

Answer. After the Treasury Inspector General for Tax Administration (TIGTA) review on the accuracy of IRS.gov, the IRS implemented several controls to ensure taxpayer concerns regarding the web site are directed to the appropriate IRS.gov Point of Contact (POC). The IRS also issued more specific procedures to the IRS.gov Helpdesk vendor regarding the handling of IRS.gov inquiries (comments, questions and problems) from web users, to ensure the vendor is forwarding those inquiries for resolution. Inquiries from web users regarding the accuracy of the web site or inquiries that indicate that information on the web site is different from other web documents are immediately forwarded to the IRS.gov POCs for resolution.

The IRS has also added a staff member dedicated to monitoring the resolution of inquiries forwarded to the IRS.gov POCs to ensure that these inquiries are addressed. The IRS has also implemented the use of Unresolved Escalation Reports to follow-up on unresolved inquiries with the Content Area Administrators and, when necessary, management. If IRS.gov POCs do not respond to inquiries within designated timeframes, a follow-up is scheduled to ensure issues are resolved.

In addition, the IRS has updated its procedural document “Guidelines for Responding to IRS.gov Escalations” to provide specific responsibilities for IRS.gov POCs. On January 11, 2005, the IRS held a meeting with the IRS Content Area Administrators and explained the changes in procedures. Since January 2005, the new procedures have been effectively implemented.

PROPOSED CUTS TO TAXPAYER OUTREACH

Question. Funding for taxpayer outreach has steadily decreased in the past few years. Outreach activities include proactive programs for taxpayers, businesses, tax practitioners, and others to understand their tax obligations and have the information and materials necessary to do so. For fiscal year 2006, a 7 percent cut is proposed, which is almost the same as the increase proposed for enforcement. Doesn't cutting outreach directly conflict with your Strategic Plan to improve taxpayer service by making it easier for people to participate in the tax system? Have you been able to identify a decline in the need for outreach? Do you have data—has a study been completed to demonstrate this? If yes, please provide a copy. If there has been no decline in the need for outreach, how are you going to meet this need, if you are cutting outreach?

Answer. The change in the level of resources requested for the Outreach activity in fiscal year 2006 reflects the IRS's commitment to providing high-quality services to taxpayers in the most efficient and effective manner possible. However, the reduction in Outreach is not comparable to the increase in Enforcement resources. Outreach is a single budget activity with a relatively small budget, while the term "Enforcement" encompasses five budget activities with a substantially larger budget. A more appropriate comparison would be between the reduction in "Taxpayer Service" resources—encompassing several budget activities—and the increase in "Enforcement" resources. As proposed for fiscal year 2006, "Taxpayer Service" resources decline by 1 percent, while "Enforcement" resources reflect a 7.8 percent increase.

The IRS must provide strong customer service to taxpayers, but the way taxpayers pay their taxes and access IRS information is changing. In recent years, the use of IRS.gov and e-filing has increased rapidly while paper filing and visits to walk-in Taxpayer Assistance Centers (TACs) have declined. In fact, this filing season individuals filed more returns electronically than on paper, marking the first time in history that e-filing has outpaced paper returns. The closure of TAC sites and corresponding reduction in Outreach resources has been carefully evaluated to minimize the impact on taxpayers while simultaneously making additional resources available for other essential functions.

The number of taxpayers walking into a Taxpayer Assistance Center (TAC) for assistance has decreased from a high of nearly 10 million contacts in fiscal year 2000 to about 7.7 million contacts in fiscal year 2004. To date this filing season, traffic is down again by over 9 percent. This trend reflects the increased availability and quality of services that do not require travel or waiting in line. Examples include improved access to IRS telephone service, the increasing availability of volunteer assistance, and the many services now available through IRS.gov, such as access to all forms and publications, "Free File," and "Where's My Refund?"

These shifts present an opportunity to adjust the way the IRS serves taxpayers and to focus on the most efficient services. Changing the way the IRS provides customer service to meet the new ways people are dealing with their taxes in the 21st century allows the IRS to meet the needs of taxpayers while spending their tax dollars more efficiently and responsibly.

With respect to quality, Toll-Free telephone service is the best option for most customers to get a correct and complete answer to their tax law or account questions. Unlike the walk-in environment, the sophisticated capabilities of our Joint Operations Center allow Toll-Free customers to be routed to an IRS employee specifically trained to address their particular issues. This filing season, Toll-Free tax law and account accuracy are at 88 percent and 91.5 percent respectively. Treasury Inspector General for Tax Administration (TIGTA) audits assessed the walk-in level of tax law accuracy at 75 percent for the same time period; however, the IRS notes the TIGTA does not base its results on a statistically valid sample. The IRS is developing a new Field Assistance Embedded Quality Review System (EQRS) to determine the true accuracy rate, but it is still too early in development to yield measures of which the IRS is confident.

The Wage and Investment Division Stakeholder Partnerships, Education and Communication (SPEC) business model focuses upon the delivery of education and tax preparation services solely through community-based partners such as non-profit, social services, educational, financial, governmental, faith-based, and corporate organizations. Since inception in 2001, this collaborative partnership has increased the volume of volunteer tax return preparation from 1.1 million returns to over 2 million returns in 2005.

The IRS also believes it can streamline certain other outreach programs while meeting or exceeding the service expectations. In particular, the ongoing effort to realign and refocus communications, outreach, and liaison efforts within the Small Business/Self-Employed (SB/SE) Division will enable the IRS to enhance the level

of service and the quality of its interactions with small business taxpayers in support of its strategic plan. The core mission of this merged organization will focus efforts in three areas—practitioner liaison; stakeholder engagement; and, support of strategic compliance initiatives—and will result in the following benefits for small businesses and practitioners:

- Centralized organization and delivery of key messages to ensure national stakeholders and partners in tax administration at the local level receive consistent, accurate and up-to-date information.
- Targeted communications with practitioner groups to provide consistent information on changes to the IRS's policies and procedures and keep our stakeholders apprised of the many services we offer—such as E-services for those who file electronically on behalf of their clients.
- An enhanced Issue Resolution program to encourage and address the feedback received from small business and practitioner stakeholders and enable the IRS to continually make improvements in examination, collection, and campus operations that benefit small businesses and practitioners.
- Continued educational outreach to meet the needs of small businesses through comprehensive curriculum, which the IRS updates for all tax code changes. The website, which is dedicated to small businesses, contains about 10,000 pages of content arranged by major industry groups and by major tax areas, such as employment taxes and depreciation. Response to this site has been overwhelming. For example, in January 2005, the site had 1.7 million visitors—more than double the number from January 2004.

Finally, the IRS believes it can achieve greater efficiencies in distributing tax products by leveraging on the continuing growth in e-filing and taxpayers' increased use of Internet. For example, consolidating the IRS's forms distribution operations from three sites to one site not only will be more efficient, but also will save staff, printing and postage resources. Other savings will accrue as increased e-filing results in the need to mail fewer tax packages, and Internet downloads allow the IRS to reduce excess quantities of tax forms, publications and other tax products.

Question. Congress created the Taxpayer Advocate so that taxpayers could receive assistance in solving their problems with the IRS. However, taxpayers aren't able to take advantage of this service if they don't know about it. Research indicates that only a small percentage of taxpayers eligible for Taxpayer Advocate Services have ever even heard of the Taxpayer Advocate. To what degree will the cuts you are proposing affect the Taxpayer Advocate? Won't these cuts further erode the public's awareness of the Taxpayer Advocate?

Answer. The IRS will continue to make taxpayers aware the Taxpayer Advocate Service is available to help them solve their problems with the IRS. The proposed changes to taxpayer service—reduced outreach spending and fewer Taxpayer Assistance Centers—may minimally reduce taxpayer awareness of the availability of the Taxpayer Advocate Service (TAS). However, outreach activities that publicize TAS should continue. The reduced outreach spending will be possible due to savings in printing and postage caused by shifts to electronic filing and by providing publications on-line, rather than through the mail. Reduced IRS face-to-face assistance may increase the TAS workload as taxpayers seek such service from TAS, especially in cases where TAS is collocated with a TAC that's been closed. However, the IRS expects these impacts to be minimal because of the overall trend toward alternate forms of assistance via the Internet and the telephone. Further, VITA assistance and SPEC and TEC outreach programs will supplement IRS reductions to face-to-face service and will maintain significant support for the awareness of TAS's services.

QUESTION SUBMITTED BY SENATOR HARRY REID

Question. The National Research Program (NRP) estimates that underreporting of tax attributable to individual income tax filers is the largest component of the tax gap. The shortfall of taxes paid to taxes owed has been estimated by the IRS at being in the range of \$200 billion–\$235 billion annually. Of this amount, the Service estimates that as much as \$9 billion of this underpayment relates to errors in calculating taxable gains on the sale of equity assets. I understand that the NRP program used, on a limited basis, a computer program to help derive this underpayment estimate. Would an expansion of the use of this program assist the Service in reducing the underpayment of tax in this area?

Answer. The National Research Program (NRP) analyzed about 46,000 individual income tax returns for Tax Year 2001 and the Office of Research used the data collected in its update of the Tax Gap figures released in late March. NRP examiners

and classifiers tested computer-based tools to determine if the calculated amount of capital gains reported by the taxpayer could easily be checked. The test was inconclusive, with some examiners and classifiers saying the tool was somewhat useful and others saying it was not helpful. In large part these results reflect the fact that taxpayers do not always list the exact purchase date for assets (such as shares of stock) they sell in a particular tax year. Often, the acquisition date is given as “various,” reflecting purchases of more than one block of shares or the ongoing acquisition of shares through dividend reinvestment. Moreover, even where there is a specific acquisition date, the share price may fluctuate on that day by 10 percent or more, and it is unclear whether the taxpayer purchased the shares at the top of the range, at the bottom, or somewhere in between. Given the current level of information reporting for capital gains transactions (e.g., only gross sales proceeds are reported by brokerage firms, not the basis of the publicly-traded assets that were sold), it is not clear that the benefits generated by using a computer-based tool to help calculate basis of capital assets would exceed the costs.

Senator BOND. The hearing is recessed.

[Whereupon, at 10:50 a.m., Thursday, April 7, the subcommittee was recessed, to reconvene subject to the call of the Chair.]